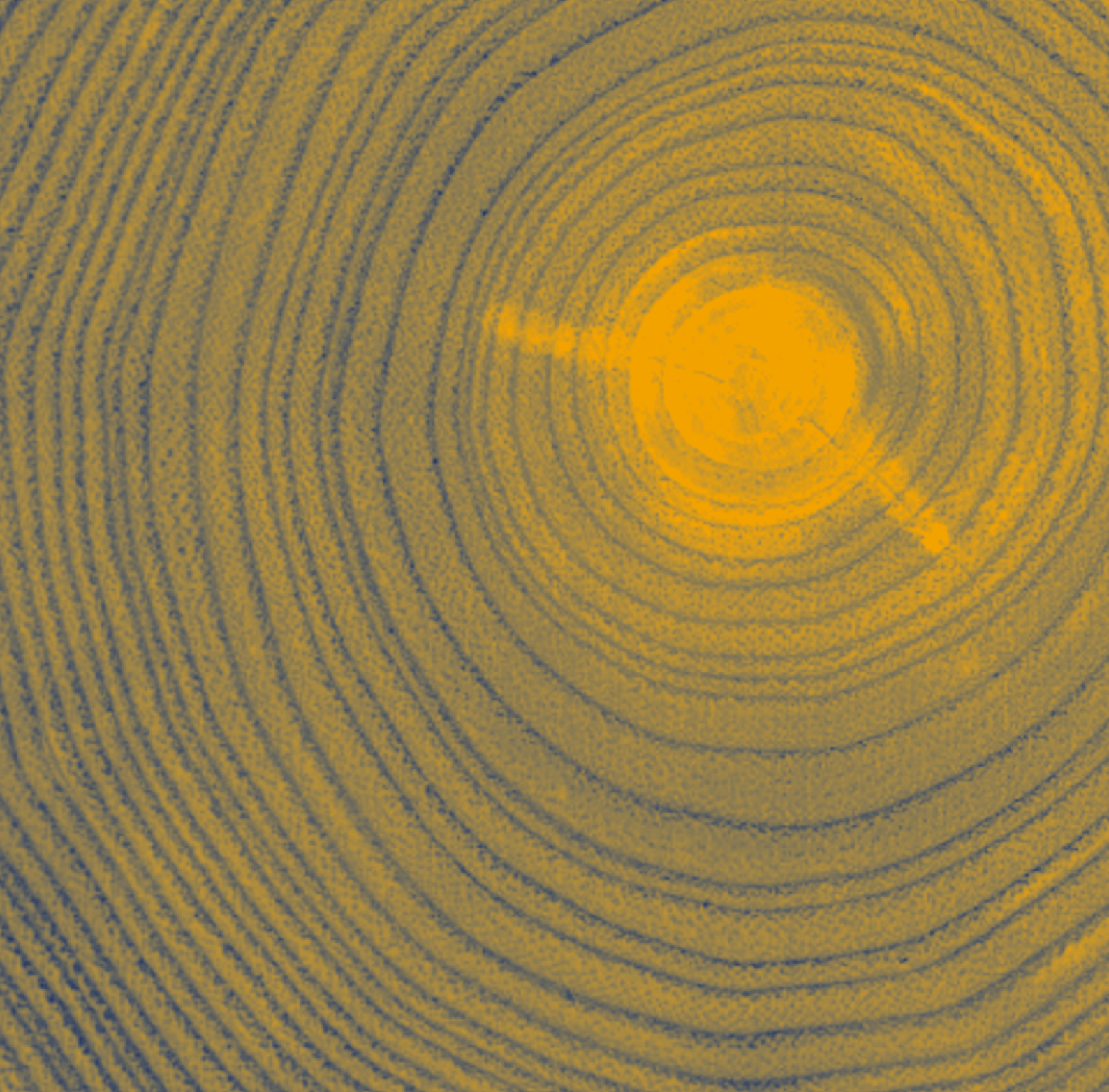




National Pensions Review

**Report by The Pensions Board to
Séamus Brennan TD
Minister for Social and Family Affairs
October 2005**

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OVERVIEW

The Pensions Act, 1990 (as amended) requires the Minister for Social and Family Affairs to cause a report in relation to the extent of the application of occupational and other pensions, and in respect of such matters as he considers relevant, to be prepared and furnished to the Minister not later than September 2006. A copy of that report is to be laid before each House of the Oireachtas within six months of its preparation.

On 3 February 2005, the Minister wrote to the Pensions Board stating that he saw little point in delaying the report until 2006 and, having discussed this at Government, he asked the Board to undertake a full review of pension coverage and associated issues without delay. The Board is strongly committed to supporting achievement of adequate retirement provision and therefore welcomed the opportunity for involvement in this important review. It confirmed that it would proceed with work on a National Pensions Review as quickly as possible with a view to making a progress report to the Minister in June and submitting the full report by October 2005.

The National Pensions Policy Initiative (1996–1998) formulated a strategy and made recommendations for a fully developed national pension system. Since then, the Board has been closely involved in supporting implementation of the recommended changes. These took place between 2000 and 2003 and this Review effectively assesses progress of pension provision since implementation of these changes. Whilst increases in pension coverage are proceeding slowly, the Board had some concerns about the timeframe of the Review in that the length of experience of the current system is very short for the purposes of assessing the likelihood of it achieving its long-term objective of adequate retirement provision for all. However, the Board is also conscious of other major external influences on pension provision. In particular, the considerable improvements in life expectancy have increased the cost and importance of good retirement provision. The Board also recognises the pressures on defined benefit pension schemes which have been adversely affected by investment returns and interest rates as well as by additional costs arising from increased life expectancy and some further requirements arising from member protection legislation.

To oversee the National Pensions Review, the Board established a Steering Committee. The main components of the Review included a public consultation process, a series of workshops for Board members and others and consultancy assistance. There was a good response to the consultation process from representative organisations and from individuals. In all, 36 submissions were received and these were incorporated in Board discussions. The four workshops also provided a wide range of views and an interesting feature of these was the degree of consensus which became apparent on many issues. All of these provided detailed information to inform the deliberations of the Board which itself includes representatives of organisations with different pension involvements.

Among the key messages which emerged from the Review was the prediction of a significant increase in the annual costs of Social Welfare retirement pensions and public service pensions which is much greater than previously expected. The underlying cause of the increased cost of Social Welfare pensions is that the projected numbers of people aged over 65 are expected to triple in the period to 2056. In the same period, the numbers at work are expected to show a much smaller increase. Another key message is that good pension provision has a very high cost. This cost arises however it is paid and whether the contributions come from employers, employees, individuals or taxpayers through the Exchequer.

The Report includes a review of previously agreed pension targets, an assessment of current coverage and adequacy and discussion of the strategic options for meeting the agreed targets. The Board accepted, with a reservation from the representative of the Minister for Finance, that the targets remained valid. Accordingly, the Board continues to recommend an overall retirement income target of 50% of pre-retirement income, a Social Welfare pension of 34% of Gross Average Industrial Earnings, and a supplementary pension coverage rate of

70% of those aged 30 and over. However, a number of Board members believe that a higher minimum pension target is needed to ensure that pensioners without supplementary pensions have an adequate income and for reasons of greater social equity. Also, whilst the Board accepted the ultimate coverage target to be achieved in the period after 2013, the Board believes that close attention must be paid to progress and recommends a further review in 2008. Most Board members went on to agree that the pension targets will not be met without some change to the present pension system.

The Report confirms that coverage and adequacy are lowest among the lower-paid, among younger members of the workforce and among part-timers. Because women comprise a greater proportion of these groups they are therefore more likely than men to have inadequate, if any, pension provision. The pension initiatives or changes aimed at the lower-paid and younger workers as recommended in the Report will benefit women. However, the Board recognises that there are other economic, social and cultural factors operating and further research and specific initiatives will therefore be needed to raise awareness among women of the need for retirement provision. The Report also emphasises the need for an ongoing and enhanced level of campaign to raise overall pension awareness.

The Board recognises that the cost of Social Welfare pensions will increase very significantly in the future, and steps will be needed to ensure that these pensions can be maintained. Consideration was given to the implications of increasing the age at which Social Welfare pensions are paid. Other ideas put forward for consideration are increasing the Exchequer payment into the National Pensions Reserve Fund which was set up in 2000 to level out the projected increase in the costs of Social Welfare and Public Service pensions, and increasing Pay Related Social Insurance contributions. A recommendation is also made that retirees should be offered the option of deferring drawing their Social Welfare pension in exchange for a larger pension starting at a later date.

In looking at the various issues where the Board believes improvement is needed, it has not lost sight of the fact that Ireland already has a good level of pension provision and a sound pensions base. The Board is therefore clear that any changes which are made should build on and around this existing base. The Board is in favour of specific enhancements to the current voluntary supplementary system. Many members of the Board consider that further enhancements of the voluntary system can, over time, achieve significant improvements in supplementary coverage and adequacy. Although some members of the Board do not think that the proposed enhancements will achieve the National Pensions Policy Initiative targets, they nonetheless support the proposed enhancements as a means of improving the current situation. The Board has identified the following proposals as its preferred enhancements and has emphasised that these proposals are seen as a group for the purposes of achieving the most impact.

The proposals recommended by the Board are that:

- The State incentive for personal contributions to Personal Retirement Savings Accounts be granted by means of a matching contribution of €1 for each €1 invested, rather than through tax relief, subject to a maximum amount. These contributors would also be allowed a limited access to their funds before the age of 45
- Tax relief for other forms of supplementary pension provision be allowed at the higher rate for all personal contributions
- The point of sale regulation of Standard Personal Retirement Savings Accounts be reduced by eliminating the requirement to prepare a fact-finding questionnaire
- Incentives be introduced to encourage the proceeds of Special Savings Investment Accounts to be saved for retirement. These incentives should be targeted at those who would not otherwise qualify for tax relief, or who have not recently fully availed of their tax relief entitlement.

As a contribution towards the cost of providing incentives to the lower-paid at the same rate as higher-rate taxpayers, the Board supports imposing a cap on incomes for pension contribution and benefit purposes, but only if the derived savings are used to improve incentives for the lower rate and non-taxpayers.

Some other Board members believe that a mandatory approach is the only certain way of achieving the agreed targets and that such an approach should be considered urgently. However, others believe that the cost of the certainties which can be provided by a mandatory supplementary pensions system is too great in terms of potential economic and other impacts.

Board members, apart from the representative of the Minister for Finance, believe that the proposal for State retirement support should be pursued vigorously. This should include examination of the potential for provision by the State of annuities for retired members of defined benefit schemes which have been wound up involuntarily, provision by the State of annuities for holders of small pension funds, and a State guarantee of investment returns on Standard Personal Retirement Savings Accounts.

Whilst it was not practical or appropriate to revisit the recent review of the defined benefit Funding Standard as part of this Review, the Board is aware of the concerns which have been expressed and will give consideration to whether it should recommend any further changes to the Funding Standard following completion of this Report. The Board also intends to further consider the question of a pension protection fund, taking account of practical and technical issues and of international experience.

The Board is very conscious of the importance of retirement provision for the welfare and quality of life of the people of Ireland. It must always be remembered that adequate retirement provision has an enormous personal impact on individuals. Ireland is currently faced with the prospect of almost half of the workforce retiring with no provision to replace their income with anything other than Social Welfare pensions. In many cases this would have very serious consequences in terms of the quality of life of those individuals. Retirement provision will also have a major impact on the future progress of the Irish economy and the scale of the issue has the potential to result in very serious consequences for the country at a macro-economic level.

Favourable Irish demographics give Ireland a window of opportunity to ensure adequate retirement provision, but that window is likely to have closed in twenty years time. The Board is therefore very pleased that the Minister has frequently stated his determination to address this issue now and to bring the matter to Government. The Board hopes and believes that the up-to-date costs and projections shown in this Report and its conclusions and recommendations will make a sound contribution to future decision making on pension provision. The Board understands that further decisions must be made in the context of employment interests, competitiveness and overall economic and social considerations.

The Board completed its Report between February and October 2005 in accordance with the timeframe agreed with the Minister. It includes as much analysis and research as possible in the time available but there are some areas in the Report where further work is recommended. The Report includes a timetable of next steps which sets out the principal recommendations for immediate implementation and also areas identified for further consideration and debate. The Board is available to provide appropriate elaboration on any issues which the Minister considers relevant.

The Board would like to thank the organisations and individuals who participated in the consultation process, the consultants who provided assistance and the non-Board members who made specialist inputs. The Board would also like to thank the Minister for asking it to complete this Review and it is the Board's hope that the Report will be another step towards the important objective of adequate retirement provision for all.

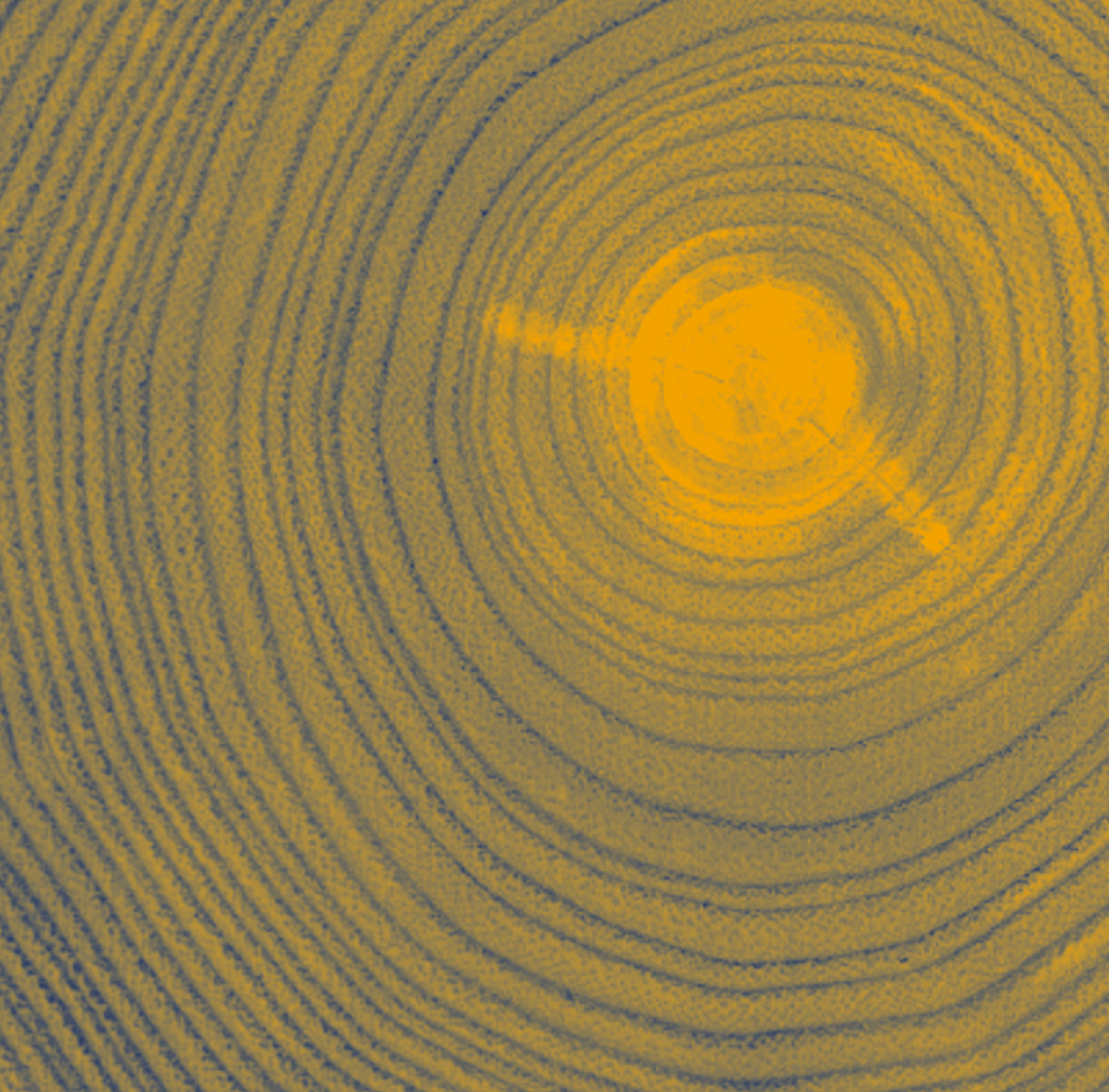
NOTE ON TERMINOLOGY

Some terms and abbreviations used in this Report may be unfamiliar to some readers, and a glossary has been provided on page 104. However, the most important terms used throughout are:

First Pillar Pensions	Retirement pensions paid by the State under its social protection programme. In Ireland these are the Old Age (Contributory) Pension, Old Age (Non-Contributory) Pension and Retirement Pension.
Supplementary Pensions	Pensions received in addition to first pillar pensions. In Ireland these may be from Occupational Pension Schemes, Personal Retirement Saving Accounts or Retirement Annuity Contracts.
Coverage	A measure of the proportion of the workforce that have supplementary pensions.
Adequacy	A measure of how much pension will be provided at retirement compared to earnings before retirement. This includes both first pillar and supplementary pensions.

Some amounts are also used in this Report as reference points. The terms will be familiar but it is also useful to be aware of the actual amounts to which reference is being made. The most important terms and amounts are:

Old Age (Contributory) Pension (OACP)	Currently the maximum rate is €179.30 per week, €9,323.60 per annum
Gross Average Industrial Earnings (GAIE)	At end of 2004, €560.77 per week, €29,160 per annum
Gross National Product (GNP)	The estimated 2004 GNP used was €121.8 billion



CHAPTER 1

SUMMARY, RECOMMENDATIONS AND NEXT STEPS

CHAPTER 1 – SUMMARY, RECOMMENDATIONS AND NEXT STEPS

Background (Chapter 2)

- 1.1 The National Pensions Policy Initiative (“NPPI”), which was completed in 1998, formulated a strategy and made recommendations for a fully developed national pensions system. The purpose of the National Pensions Review (“NPR”) is to review the current national pensions system with particular reference to the targets set out in the NPPI report in 1998, entitled ‘Securing Retirement Income’ (“NPPI Report”). Section 102(2) of the Pensions Act requires a report on “the extent of the application of occupational and other pensions, in respect of such matters as the Minister [for Social and Family Affairs] considers relevant” to be prepared by September 2006. In February 2005, the present Minister wrote to the Pensions Board (“the Board”) requesting the Board to undertake the statutory review during 2005, the review to examine alternative approaches to national pension provision and the report to contain proposals designed to “deliver on the commitment to ensure an adequate retirement income for all” (letter at Appendix 1).

A Board Steering Committee oversaw the NPR process which included consultation, workshops and some consultancy assistance.

Review of NPPI targets (Chapter 3)

- 1.2 In summary, the targets recommended in the NPPI Report for retirement income are:

- A target replacement income of 50% of pre-retirement income before tax; and
- An overriding minimum income of 34% of gross average industrial earnings (“GAIE”).

The NPPI Report also concluded that, in order to achieve the replacement income target, supplementary pension coverage would be needed for 70% of the working population aged over 30.

- 1.3 The Board, with the exception of the representative of the Minister for Finance, is still of the view that the NPPI replacement income target of 50% of gross pre-retirement earnings remains the appropriate one to secure income adequacy in retirement. This target is of especial relevance to lower income groups who are unlikely to have significant non-pension assets upon which to draw in retirement.
- 1.4 The NPPI Report proposed a target rate of 34% of GAIE for the Old Age (Contributory) Pension (“OACP”), to be achieved over a 5 to 10 year period. At the time of the NPPI Report, the post-Budget 1998 pension equalled 26% of GAIE for 1997. The 34% target was not adopted by the Government as a policy. However, the Government has since set a target of OACP of €200 per week by 2007. The 2005 OACP of €179.30 per week represents 32% of 2004 GAIE and 30.5% of estimated 2005 GAIE.
- 1.5 The original NPPI minimum income target was arrived at mainly (but not exclusively) after consideration of measures of poverty and what income would be necessary to avoid such poverty. At the time of the NPPI Report, there was comparatively little information available on relative poverty. However, since then, considerably more data have become available, and this measure is of increasing importance, particularly in EU comparisons.
- 1.6 Since 1998, the OACP has increased by 88%, compared to an increase in GAIE of 51%. The result has been a fall in the proportion of those aged over 65 experiencing basic deprivation.
- 1.7 However, measures of relative income (i.e. income relative to others in society rather than an absolute measure of what income is required) show that the risk of poverty for those in retirement has increased. A comparison of 1994 data with 2003 data (the most recent available) shows that the proportion of those retired at risk of relative poverty has increased from 6.0% to 31.0%.

The most common measure of relative poverty is the risk-of-poverty line, which is often presented as 60% of the median household income, adjusted for family size. Although pensions have increased by considerably more than GAIE, median household income has grown by even more. The two main drivers of this growth were:

- Reduction in unemployment and increased participation by women in the workforce
- Tax concessions which benefited those in employment.

Neither of these factors had any significant effect on those on Social Welfare pensions.

Further analysis shows that the OACP is now below the risk-of-poverty line.

1.8 The Board, with the exception of the representative of the Minister for Finance, accepts 34% of GAIE as a minimum target for OACP as proposed in the NPPI Report. However, a number of Board members believe that a higher minimum pension target is needed to ensure that pensioners without supplementary pensions have an adequate income by reference to household incomes generally. Other Board members also support an increase in the basic income target for reasons of greater social equity.

1.9 Having accepted the targets for post-retirement income and for first pillar pensions, it is reasonable to estimate what proportion of the population will require supplementary coverage, in order to achieve the income target. In this context, the Board believes that a coverage target must be measurable and within an unambiguous timeframe.

1.10 The Board accepts the continuation of the NPPI ultimate coverage target of 70% of those working who are aged over 30. This is an ultimate target, to be achieved in the period after 2013, and is to take account of such factors as structural changes in the labour force over time. The Board is of the view that the base date for measuring progress against interim targets should be September 2003, which is the date on which employer access requirements for Personal Retirement Savings Accounts ("PRSAs") came into force.

However, close attention must be paid to the progress towards the targets, and the Board intends to explore what further information can be gathered to allow pension coverage to be measured in a more precise and useful way and to put in place appropriate interim and subsidiary coverage targets. The Board recommends a further review of progress in 2008.

Review of current coverage and adequacy (Chapter 4)

- 1.11 Considerable progress has been made, by budgetary increases, towards the agreed target value for first pillar pensions of 34% of GAIE and to ensuring long-term sustainability by means of the National Pensions Reserve Fund ("NPRF"). National policy has also achieved coverage of almost the entire working population for OACP, and those not entitled to OACP are entitled, subject to a means test, to the Old Age (Non-Contributory) Pension ("OANCP").
- 1.12 Supplementary coverage is insufficient and is a cause for concern. The numbers in the workforce are now considerably higher than was anticipated in the 1990s. It is likely that the increase in the workforce has made the supplementary pension coverage percentage lower than it would otherwise have been. In the short-term, those who have recently joined the workforce are less likely than others to voluntarily consider pensions coverage. This illustrates how sensitive the coverage levels are to changes in the composition of the workforce, and how difficult it is to draw definitive statistical conclusions with only two years' experience. Indeed, it should also be remembered that almost twice as many people have supplementary provision today compared to 1995 and this number is greater than was targeted for 2013 (see Table 4.5).

However, in the same period, the numbers working have also almost doubled, as a result of reduced unemployment, higher female participation, and immigration, and hence the lack of a significant percentage increase in coverage.

- 1.13 A number of submissions received as part of the NPR have suggested that savings outside the pensions system comprise significant additional retirement provision, and in particular that property investment comprises an important new factor to be taken into account. As in other countries, data are sparse on wealth amount and distribution in Ireland. However, the Board is most concerned about pension coverage among those aged under 50 on medium and lower incomes. The Board does not believe that property or other asset ownership is significant among this group but recognises that further research in this area would be very useful.

- 1.14 The Board's views on the development of supplementary private pension coverage are:

- The current level of coverage continues to be a cause of concern, particularly for women and lower income workers
- It is not possible to draw any definitive conclusions at this stage from the Central Statistics Office (CSO) pension coverage statistics alone
- A number of Board members are of the view that it is too soon after the implementation of the major NPPI Report recommendations in 2003 for a comprehensive review of progress towards the NPPI targets
- A number of members of the Board believe that coverage targets need to be viewed as goals to be attained in a broad, flexible manner, on the basis that account must be taken of structural changes in the labour force over time.

- 1.15 Although focus on progress towards the NPPI targets has understandably been on the coverage target, this target must be seen as only the first step towards achievement of the 50% income target, and the Board would be concerned were this income target lost sight of.
- 1.16 From a range of sources a reasonably complete picture of typical supplementary provision can be formed as follows:
- Most public service schemes provide benefits which will provide adequate retirement income over a working life
 - The majority of private sector defined benefit schemes will provide benefits greater than the NPPI adequacy target at retirement for those with long service
 - Because of typical contribution levels, commonly about 10% of income, the great majority of defined contribution scheme members are unlikely to have a retirement income equal to or greater than the NPPI target
 - Information relating to PRSAs and Retirement Annuity Contracts ("RACs") seems to indicate that typical contributions are less than for occupational pension schemes ("OPSs")
 - Even where an OPS provides benefits close to the NPPI target level, inflation can erode the value of the benefits surprisingly quickly. No definitive figures are available, but it is generally accepted that about one third of OPSs provide guaranteed increases, and a further third provide ex gratia increases, but few of those would provide increases equal to the rate of inflation
 - Since the NPPI Report was published, there does not appear to be any improvement in the adequacy of pension provision. Defined benefit schemes represent a reducing proportion of employer sponsored second pillar pensions, and there is no evidence of significant increase in the contribution level of typical defined contribution arrangements.

- 1.17 Pension coverage is lower for women than for men. The proportion of pension contracts begun by women is considerably less than their share of the workforce. Furthermore, PRSA and other data show that the average pension contributions made by women are less than by men, even after adjusting for differences in age and income.
- 1.18 Any pension initiatives or changes aimed at the lower paid and younger workers will benefit women, and help close the provision gap. However, further awareness initiatives will be needed to specifically increase pension awareness among women.
- 1.19 It is the view of most of the Board that the NPPI coverage and adequacy targets will not be met without some change to the present pension system. However, a number of Board members believe that insufficient time has elapsed since the implementation of the NPPI recommendations to draw clear conclusions.

Sustaining the first pillar (Chapter 5)

- 1.20 Calculations prepared by Life Strategies Limited and ESRI ("LS/ESRI") project a significant increase in the annual costs of first pillar pensions. In addition a significant increase in public service pension costs is also projected. It is the Board's view that the projected increase in these costs is a significant challenge to pension provision.
- 1.21 The underlying cause of the increased first pillar cost is that the ratio of those at work to those aged over 65 is projected to change from 4.3 people at work for each person aged over 65 in 2006 to 2.7 for each 1 in 2026 and to 1.4 for each 1 in 2056.
- 1.22 The cost of first pillar pensions for those over 65 plus the cost of public service pensions is projected to increase from 4.3% of Gross National Product ("GNP") in 2006 to 7.7% in 2026 and to 13.8% in 2056. The projected first pillar costs are considerably higher than those prepared for the last actuarial review of the Social Insurance Fund as at end December 2000, and reflect a combination of rapidly increasing life expectancy and dramatic changes to the patterns of migration.

These projections of pension costs are not predictions and must not be used as such. Rather they are best estimates of the future situation based on a set of reasonable assumptions. It is important that future pension costs continue to be projected at regular intervals as a basis for policy debate and formulation.

- 1.23 In principle there are four options available to deal with the increasing cost of first pillar pensions. These are:
- to reduce the value of first pillar pensions
 - to meet the increased costs from increased taxation and/or Pay Related Social Insurance ("PRSI") contributions
 - to defer the age at which retirement benefits are paid
 - to increase the advance provision, currently made through the NPRF.

In practice, the policy is likely to be a combination of a number of the options listed above. However, the Board does not support any reduction in the level of first pillar pensions. It should also be noted that the scale of taxation/PRSI increases needed to meet the increased cost in full means that other approaches will need to be considered as well.

- 1.24 Increasing life expectancy means that first pillar pensions are paid for longer, and so are more valuable. Since 1991, life expectancy at 65 has increased by 2 years for men and by 1.6 years for women. It is projected to continue to increase by more than one year each decade. The longer life expectancy, which is very welcome, is a worldwide trend and, in Ireland's case, is enhanced by increased wealth and better health.

If the age from which the first pillar pensions were paid was raised for all, there would be a reduction of approximately 5% of the total cost for each year by which the retirement age was raised. The question of increasing retirement age for first pillar benefits has or is being considered in many countries, though usually where the retirement age is less than 65. It is common for any changes to the retirement age to be introduced gradually, so that a higher retirement age applies only to those with more recent years of birth.

- 1.25 The primary argument in favour of increasing retirement age is financial, but a further argument in favour of such an increase is on grounds of inter-generational equity. Among the arguments against any increase in retirement ages are:

- First pillar pensions are seen as a contract between contributors and the State which should not be changed unilaterally
- Any increase in the retirement age would have a proportionately more detrimental effect on the less well off.

- 1.26 It has been suggested that those entitled to the OACP should be allowed to defer the start of their benefits in exchange for a higher benefit beginning later. Those who have the opportunity to continue in employment and wish to do so could then accrue extra retirement benefits, both through additional first pillar entitlements and through having extra time to make supplementary provision.

Many feel that the current OACP is too low. This proposed flexibility would at least provide higher benefits for those in a position to defer drawing their benefits.

The operation of the State Retirement Pension ("SRP") between 65 and 66 is a significant practical obstacle to this proposal. This pension is only paid to those who have retired, and so allowing credit for all who defer their pension may incur significant additional Exchequer costs.

- 1.27 The Board recommends that retirees should be offered the option of deferring drawing their first pillar pension in exchange for a larger pension starting at a later date.

- 1.28 One suggestion made to the NPR has been that members of OPSs would have the option (but not the obligation) to remain in employment beyond the retirement age of their OPS and accrue additional pension entitlements.

- 1.29 It is important to emphasise that this proposal would only affect those who wished to continue in employment. It could be implemented by prohibiting the imposition of mandatory retirement, or by prohibiting any mandatory retirement before, say, 68 or 70 except for a small number of occupations. This would allow employees more flexibility in meeting their retirement savings needs.

- 1.30 However, it is said that some employees, especially in manual occupations, would not be physically able to work beyond 65 and in some cases even before that. Were the mandatory retirement age raised or removed, there might be employees who wished to continue working but were not capable of doing so, and assessment procedures would have to be invoked by employers.

The view of the representative of the Minister for Finance is that, in the years ahead the relative scarcity of younger workers will lead employers to retain older workers and to invest in the upgrading of the skills of those workers. Given the increased incidence of older people in the consumer market, it will be in employers' interest to have older workers in their workforce for ease of communication with an ageing market. It should be left to the industrial relations process to develop a workforce where employees' rights to work for as long as they wish are balanced by employers' rights in regard to a productive workforce geared to market needs.

- 1.31 The NPRF was established with the objective of pre-funding as much as possible of the demographically induced increase in the cost of first pillar and public service pension provision. It was estimated at the time of its establishment that the NPRF would cover approximately one-third of this cost increase. However, the cost of these benefits is likely to be significantly greater than originally estimated. It should therefore be considered whether the current Exchequer contribution to the NPRF should be increased.

Among the issues to be considered in a discussion of pre-funding of first pillar pensions are:

- The existence of a substantial NPRF will both make it easier for future Governments to meet contributors' expectations, and make it less acceptable to reduce entitlements
- Future pensions can only be paid from the wealth generated by the working population at the time the pension is paid, through taxation (i.e. Pay As You Go ("PAYG")), by asset sales on behalf of retirees to the working population (i.e. pre-funding) or by a combination. Given the projected increased numbers of pensioners per worker, the scale of tax increase needed may not be sustainable. Hence the argument that the pension commitments should be at least partially pre-funded

However the difference between funding and PAYG is only a different means of organising the future transfer of assets. In particular, the price that pension assets realise will fall if non-pensioners are not willing or able to buy those assets. The difference between funding and PAYG is the difference between the uncertainty of future asset values and the uncertainty of future taxation

- It should be pointed out that the problems of selling assets in the future are unlikely to be avoided by investing overseas. The challenges of providing pensions to a greatly increased number of claimants will occur at the same time or after it happens in many other countries

Overseas investment reduces investment risk, because the future return on those assets is not dependent on the future of the Irish economy. Against this it is argued that the considerable assets of the NPRF should be invested productively in Ireland rather than overseas

- It may be politically impractical to maintain a large NPRF fund and to maintain contributions to it in years of budgetary difficulty
- Any pre-funding of the pensions of the current generation can only be made from current tax revenues, i.e. from the resources of the current generation. This generation will therefore end up paying both for the pensions of the previous generation through PRSI and, at least partly through taxation, for their own. However, it may be seen as the only way for this generation to ensure that their expectations are met
- Increased pre-funding would divert resources required for other areas of the economy, such as infrastructure, health, long-term care and education.

- 1.32 The cost of first pillar pensions will increase very significantly in the future, and steps will be needed to ensure these pensions can be maintained. Among the ideas that could be considered, in addition to or as an alternative to PRSI or taxation increases, are:

- Increasing, on a phased basis, the age at which first pillar pensions are paid
- Increasing the Exchequer payment into the NPRF.

Strategic options for meeting NPPI targets (Chapter 6)

- 1.33 There are a number of possible approaches to providing retirement income in excess of the current first pillar pensions. The spectrum of potential structures includes:
- Flat rate State provision – i.e. a significant increase in the level of current first pillar pensions
 - Earnings related State provision – this could be linked directly to earnings or to earnings related contributions, and would be mandatory
 - Mandatory private provision
 - Incentivised voluntary private provision – this is the current system
 - Neutral voluntary private provision – i.e. no incentive for supplementary provision.
- 1.34 The OACP is progressively redistributive: those on higher incomes contribute more than those on lower incomes, but receive the same benefit. The supplementary system is not intended to be redistributive (progressively or regressively), but there are a number of aspects of the operation of tax incentives that are regressive:
- Because tax relief is granted at a contributor's marginal rate, higher rate taxpayers receive proportionately more relief
 - Higher earners are more likely to be members of supplementary pension arrangements than lower earners, and tend to contribute more, and so get more tax relief
 - The tax free lump sum at retirement benefits higher earners more than lower earners.
- 1.35 The amount of tax reliefs on pension contributions granted each year does not reflect the true cost of those reliefs, as the reliefs generate additional tax revenue in future years.
- 1.36 The Board's view is that, if incentives for the lower rate and non-taxpayers were to be improved, a contribution towards the cost could be achieved by imposing a cap on incomes for pension contribution and benefit purposes, but only if the derived savings are used to improve incentives for the lower rate and non-taxpayers.
- 1.37 State support for pensions comprises first pillar pensions currently being paid to pensioners and tax incentives for those in employment saving for retirement from current earnings. It is appropriate to consider whether the support is reasonably distributed between the two areas, but in doing so, it is important to calculate the cost of that support accurately.
- 1.38 It is the Board's view that State support for current pensioners and current contributors are separate pension policy issues and should be considered separately, especially as different groups of people are involved. There is no obvious direct means of assessing the appropriate balance between these policies, and each should therefore be considered on its own merits.
- 1.39 The Board chose five pension systems to be examined in depth. These systems were chosen solely to ensure that a wide range of alternatives would be examined and do not necessarily represent the Board's preferred options. The Board commissioned a report from LS/ESRI to provide a quantitative and qualitative assessment of the current pension system and the alternative pension systems.

1.40 An outline of the five alternatives is as follows:

Alternative 1	Similar to the current pension system except that income tax relief on supplementary pensions would be available at the top rate for lower rate and non-taxpayers.
Alternative 2	This system requires mandatory contributions to a private sector financial institution for earnings between the current PRSI threshold and twice GAIE. A contribution rate of 10% of relevant earnings was modelled, split 50:50 between contributors and their employers. This split was used only as a basis for modelling, and allows the effects of other splits to be estimated easily.
Alternative 3	Similar to alternative 2, but contributions are paid to a State defined contribution arrangement.
Alternative 4	A mandatory State system which pays benefits based on average career earnings. The relevant earnings were as for alternative 2 above, and contributions were assumed to be split equally between contributors and employers. The contributions were regarded as separate from the PRSI system. The rate of contribution was calculated to equal the long-term cost of the benefits provided.
Alternative 5	This model examined the effect of increasing the OACP to 50% of GAIE. The long-term contribution rate required was calculated separately from the PRSI contribution rate.

1.41 The projections included a considerable amount of information, which cannot be summarised easily, and readers are referred to the full report in Appendix 6. Among the most notable points are:

- Except for alternative 4, the projected benefits are considerably less than the NPPI replacement income targets
- The best measure of the cost of each of the systems is the total contribution. Alternative 5 and especially alternative 4 involve a considerable increase in total pension contributions from current levels
- The economic model used projected that any increase in pension contributions will have the effect of reducing GNP growth and increasing unemployment. The greater the projected contribution, the greater these effects will be, and alternatives 4 and 5 show the greatest projected impact.

1.42 The criteria considered when assessing whether a particular pension system (first and second pillar) would be suitable for Ireland are set out below. These apply both to the level of pension provided under the system and the means of delivery.

The criteria are:

- *Coverage* – whether or not the system is likely to achieve the coverage targets. Any system should be inclusive, i.e. it should ensure that there are no unintended exclusions
- *Adequacy* – whether or not the replacement incomes provided by the system will meet the target amounts. As for coverage, adequacy should take account of inclusiveness, and any assessment of adequacy should take account of the time to achieve it
- *Cost* – the cost of benefits is the combination of adequacy and coverage, plus administration costs. Cost can be divided among any combination of employer, employee/individual and Exchequer. The division of cost has impacts on other areas such as pay structures, employment, competitiveness and the overall allocation of tax revenue. A related issue is sustainability, i.e. the progress of cost over time and its affordability

- *Simplicity* – this is a measure of how clearly the participants understand their pension provision, and can be seen as the predictability of the benefits provided by the system
- *Continuity* – how similar the system being examined is to the current system and whether any changes can be easily integrated. Any change has the potential to cause changeover costs and make the resulting benefits more complex and so impact on cost and simplicity, and possibly create anomalies of coverage or adequacy
- *Modernisation* – the EU defines modernisation of a pension system as how well it facilitates labour mobility and flexibility
- *Redistribution* – this considers how closely benefits provided match contributions made. Usually, first pillar pensions are deliberately redistributive, whereas second pillar arrangements do not aim for redistribution
- *Competitiveness* – how a system being considered is likely to impact on individual employer competitiveness or the competitiveness of the economy as a whole
- *Choice* – how much choice a system will allow to individuals both in terms of participation and in terms of how benefits can be paid
- *Robustness* – a pension system should be robust enough to deal with changes in economic circumstances
- *Acceptability* – how likely a pension system is to gain the support of those groups necessary to its successful implementation.

Enhancements to the supplementary system (Chapter 7)

- 1.43 There have been a considerable number of suggested changes to aspects of the current voluntary supplementary system, and Chapter 7 of this Report examines a number of these suggestions. The Board is well aware that no single change to the current voluntary system will on its own achieve the NPPI targets, but the cumulative effect of a number of the proposals may make a significant difference.

The approach adopted was to examine specific proposals individually in sections 7.4 to 7.39. The Board then examined a number of combined proposals, and the conclusions and recommendations are as set out in sections 1.59 and 1.61 below.

The representative of the Minister for Finance has confirmed that the Department of Finance will consider the proposals involved in the light of their economic and budgetary implications, the findings of the examination currently in progress on pensions-related tax reliefs and the needs of other areas in the economy.

“Higher Rate Tax Relief”

- 1.44 The first incentive considered was the proposal to make tax relief available to all contributors at the higher rate of 42%, rather than at each individual’s marginal rate.

Because the support for supplementary pensions is given through tax relief, there is less incentive for pension saving for those in lower tax bands than there is for higher earners. This proposal is intended to address both the question of the effectiveness of the tax incentive and the issue of equity.

“Tax Credit/Matching Contribution”

- 1.45 A number of submissions proposed that the incentive for supplementary pensions should be provided by means of a partial contribution match (as for Special Savings Investment Accounts (“SSIAs”)) rather than as tax relief. Almost all of these submissions proposed a matching contribution rate that would be the same for all contributors rather than depending on their individual marginal income tax rates. The effect of such an approach would be to combine the advantages of the SSIA approach with equity for all taxpayers. There was a range of suggested rates for the matching contribution from 66% to 128% of the individual’s contribution.
- 1.46 This suggested change to the means of granting tax relief is based on the success of the SSIA structure where the Exchequer subsidy was paid in a very straightforward and transparent way. The public response to SSIAs is believed to be due in large part to this approach.

“Capture SSIA Savings”

- 1.47 There have been a variety of proposals made to encourage holders of SSIAs to convert their savings into pensions. The main suggestions made were:
- Waive exit tax
 - Waive pension contribution limits for a set period (possibly subject to conditions)
 - Additional incentives (particularly for lower paid).
- 1.48 The background to these suggestions is the fact that this is a group proven to be susceptible to incentives to save.

“PRSA Regulation”

- 1.49 The Board received a number of submissions to the NPR calling for a reduction in the regulation of PRSAs.
- The administration and sales of PRSAs are subject to regulation by the Board, the Revenue Commissioners, and the Financial Regulator. PRSA providers have cited the regulatory burden as a significant contributory factor to the relatively low sales of PRSAs.

“PRSA Charges”

- 1.50. One suggestion made was to increase the maximum charges permitted under Standard PRSAs in order to create greater incentives for providers to sell the products. A separate submission proposed that the per-contribution Standard PRSA charge be eliminated, and replaced by a higher annual fund charge.

“Access to Funds”

- 1.51 A considerable number of submissions to the NPR proposed that pension savers should be allowed to withdraw some portion of their savings before retirement.
- 1.52 Many people cite the long-term nature of pension savings as a significant reason why many choose not to save for retirement, or fail to avail of the tax incentives for pension savings. These proposals suggest that if people are allowed to access some of their pensions savings, the remaining amount that they save for retirement will nonetheless be greater than it would otherwise have been, i.e. had they not saved at all.

“Pension Accounts for Children”

- 1.53 A number of submissions proposed that savings accounts could be set up for children with the benefit of an Exchequer subsidy. A set proportion of the proceeds of these accounts would be available at a stipulated age (25 has been suggested) while the balance would be used to provide a pension at retirement. The proposals envisage a set payment for every child into a special account, and a partial match by the Exchequer of further contributions made on the child’s behalf.
- 1.54 The background to this proposal is the improving life expectancy of recent years, which is expected to continue to rise. This proposal is a response to the cost of longer retirement by increasing the period of retirement savings.

A further objective of this proposal is to foster an awareness of the need for retirement savings among the young, and to create a savings habit. It is part of this proposal that it be linked with an ongoing education and awareness policy.

“Universal ARFs”

- 1.55 It has been proposed that Approved Retirement Funds (“ARFs”) be made available to all pension savers.
- 1.56 There is evidence that the introduction of ARFs from 1999 resulted in increased interest in and contributions to supplementary retirement savings. The purpose of this proposal would be to extend the advantages and the resulting pension interest to the remaining groups currently ineligible for ARFs.

“Automatic enrolment”

- 1.57 It has been proposed that, on beginning employment, all employees who do not immediately join a pension plan must, through a statutory obligation on employers, be included in a PRSA or similar arrangement, and have 5% deducted from earnings. Employees would have the right to opt out.
- 1.58 This proposal is based on the view that many people are aware of the importance of pensions and savings, but just never quite get around to it. However, it is thought that once they are signed up, many people would be unlikely to opt out.

Board’s views and recommendations

- 1.59 The Board is in favour of specific enhancements to the current voluntary supplementary system. Many members of the Board consider that further enhancements of the voluntary system can, over time, achieve significant improvements in supplementary coverage and adequacy. Although some members of the Board do not think that the proposed enhancements will achieve the NPPI targets, they nonetheless support the proposed enhancements as a means of improving the current situation.
- 1.60 The Board was guided by a number of factors in identifying the enhancements which it believes would be most successful in improving coverage and adequacy. These were:
- Any changes to the current system should prioritise those groups where coverage and adequacy is of greatest concern
 - Changes must increase the attractiveness and visibility of pensions to the target groups and be as efficient and focussed as possible
 - The maturing of SSIsAs is a once-off opportunity to engage a large number of people in pensions savings.

1.61 The Board has identified the proposals set out below as its preferred enhancements:

- The Board recommends that the State incentive for PRSA personal contributions be granted by means of a matching contribution of €1 for each €1 invested rather than through tax relief, subject to a maximum amount. The Board also recommends that these PRSA contributors be allowed a limited access to their funds before the age of 45
- The Board recommends that tax relief for other forms of supplementary pension provision is allowed at the higher rate for all personal contributions. This should apply through the current method of granting relief at source or through a method of refundable tax credit, where appropriate
- The Board recommends that the point of sale regulation of Standard PRSAs be reduced by eliminating the requirement to prepare a fact-finding questionnaire in such cases
- The Board recommends that incentives be introduced to encourage the proceeds of SSIA's to be saved for retirement. These incentives should be targeted at those who would not otherwise qualify for tax relief, or who have not recently fully availed of their tax relief entitlement as follows:
 - A once-off increase in pension contribution limits for those who had not fully used their pension contribution allowances in the recent past
 - Exemption from SSIA exit tax on transfer to pensions where no income tax relief is also being claimed on the amount being transferred.

As a contribution towards the cost of providing incentives to the lower paid at the same rate as top-rate taxpayers, the Board supports imposing a cap on incomes for pension contribution and benefit purposes, but only if the derived savings are used to improve incentives for the lower rate and non-taxpayers.

1.62 The Board is of the view that further awareness campaigns should form an important part of any voluntary pension system, with continued emphasis on the Board's priority groups of women and the lower paid.

Mandatory pension provision (Chapter 8)

1.63 The NPR considered mandatory supplementary pension systems in general rather than considering in depth the details of possible systems.

1.64 Ireland already has a mandatory pension system in the form of the PRSI based OACP. The Board strongly supports this system of provision. Given the first pillar system that already exists, what is considered in Chapter 8 is a mandatory pension system intended to provide a retirement income greater than that necessary to avoid poverty.

1.65. Any consideration of mandatory supplementary pensions must clearly distinguish between the effects of a mandatory system and the cost of achieving the NPPI targets. The NPPI target of 50% replacement income cannot be achieved without almost doubling the aggregate private sector retirement contributions currently being made, whether the targets are to be achieved through mandatory or voluntary contributions.

1.66 Below are set out the main arguments that have been advanced for and against a mandatory supplementary pension system:

- Some believe that many of those without supplementary retirement provision are not making informed decisions or never quite get around to doing anything about pension provision. There are different views on how much public awareness and behaviour can be changed by voluntary means

- Many people believe that a retirement income of more than the first pillar pension is a personal choice and responsibility, and that it is not up to the State to make this decision on their behalf. Others feel that it is appropriate to oblige individuals to make pension savings, and that they will not with hindsight consider these contributions wasted
- There are differing views about whether or not employers have a responsibility to contribute to pensions for their employees
- Mandatory pension contributions may cause difficulties for those who cannot afford to make supplementary provision, depending on the eligibility rules of the mandatory system
- Many people have expressed concern about the effect of mandatory pensions on employer costs. They believe that any addition to employer costs will have an inevitable effect on the viability of small companies and on international competitiveness
- Much opposition to mandatory supplementary pensions concerns the effect that such a system would have on existing supplementary provision. There is a concern that a relatively low level of mandated provision would also become the norm for many individuals and employers
- The case for a mandatory private sector system would have to be assessed in the light of the industry's ability to provide a fair, comprehensive, competitive and comprehensible service to a largely financially-unsophisticated public, the likely effects on the taxation system and savings nationally and the implications for State liability generated by compulsion. The latter two factors, together with the cost to the Exchequer, would have to be assessed if a mandatory State-run system were being called for.

1.67 A mandatory system can be structured to achieve any given set of coverage and adequacy targets. Achieving the NPPI adequacy target can only be done at a significant cost and with serious economic implications. However, the cost of achieving the targets will broadly be the same whether this is achieved through voluntary or mandatory means.

1.68 Some members of the Board believe that a mandatory approach is the only certain way of achieving the NPPI targets, and that such an approach should be considered urgently. However, others believe that the cost of this certainty is too great in terms of potential economic and other impacts.

State retirement support (Chapter 9)

1.69 A number of proposals have been made as to how State intervention could enhance pension provision. Three specific proposals were examined as follows:

- State annuities for retired members of defined benefit schemes which have been wound up involuntarily – this could have the effect of making the funding standard less demanding
- State annuities for holders of small pension funds – the purpose would be to provide benefits more economically
- A State guarantee of investment returns on Standard PRSAs – in order to make pension saving more attractive.

1.70 The first proposal is for the State to provide annuities for defined benefit schemes which have been wound up involuntarily. It has been suggested that the State could provide cheaper annuities either because some savings may be available to the State or because commercial providers are too cautious.

The cost of buying annuities has increased considerably in the last decade for two reasons, because of falls in interest rates and expectations of increasing life expectancy. This extra cost has affected the retirement benefits of many pension savers. Furthermore, because the funding standard for retired members of defined benefit schemes is based on the cost of annuities, the increased annuity cost has increased the funding standard liabilities of many schemes, leading to higher contribution requirements which has caused difficulties for scheme sponsors.

Potential savings available to the State as a provider might arise as follows:

- Less cautious life expectancy assumptions than those made by insurers
- Higher anticipated future investment returns
- Lower administration costs, and no need for profit margins
- No need to hold solvency margins.

However, there is not a consensus on the above issues. In particular:

- There is no agreement that the State's life expectancy assumptions would be less cautious
- Higher investment returns involve financial risk to the Exchequer
- The State providing annuities in competition with the market may raise EU issues.

There was discussion among Board members about the quantum of risk involved to the Exchequer in this proposal, whether this is appropriate or not, and whether such a facility could be limited to a specific group.

- 1.71 The second proposal is that holders of relatively small PRSAs and similar funds could use their funds to top up their first pillar entitlements. This could be implemented on a basis intended to be cost neutral, or could include an explicit subsidy. Even on a cost neutral basis, it is likely to be attractive to retirees in comparison to commercial annuities because of the link to Social Welfare increases: there are questions about whether this would make a significant difference to coverage or adequacy, but there is also interest in exploring this proposal further as a means of targeting specific groups. However, it is not clear if this proposal would be allowed under EU law.
- 1.72 The third proposal is that holders of small Standard PRSAs should have their benefits underwritten by the State so that they would be guaranteed a retirement income of, for example, €1 for each €15 of contributions made. This is intended to remove uncertainty from such pension provision, and so make supplementary provision more attractive. This proposal is intended to be an incentive to supplementary pension provision, and it is not proposed that the State would charge for the guarantee.

Details that would need to be decided include whether or not the guarantee should be age related, whether there should be a cap on the amount of pension fund eligible, and whether this should be provided via a guarantee on Standard PRSA contracts or via a voluntary State savings scheme.

The transfer to the State of the very substantial life expectancy risk following the saver's exit from the labour force, in contrast to the benefit arising to the provider from selling the product in the first place and maintaining the investment account in the interval prior to the saver's retirement, would have to be borne in mind.

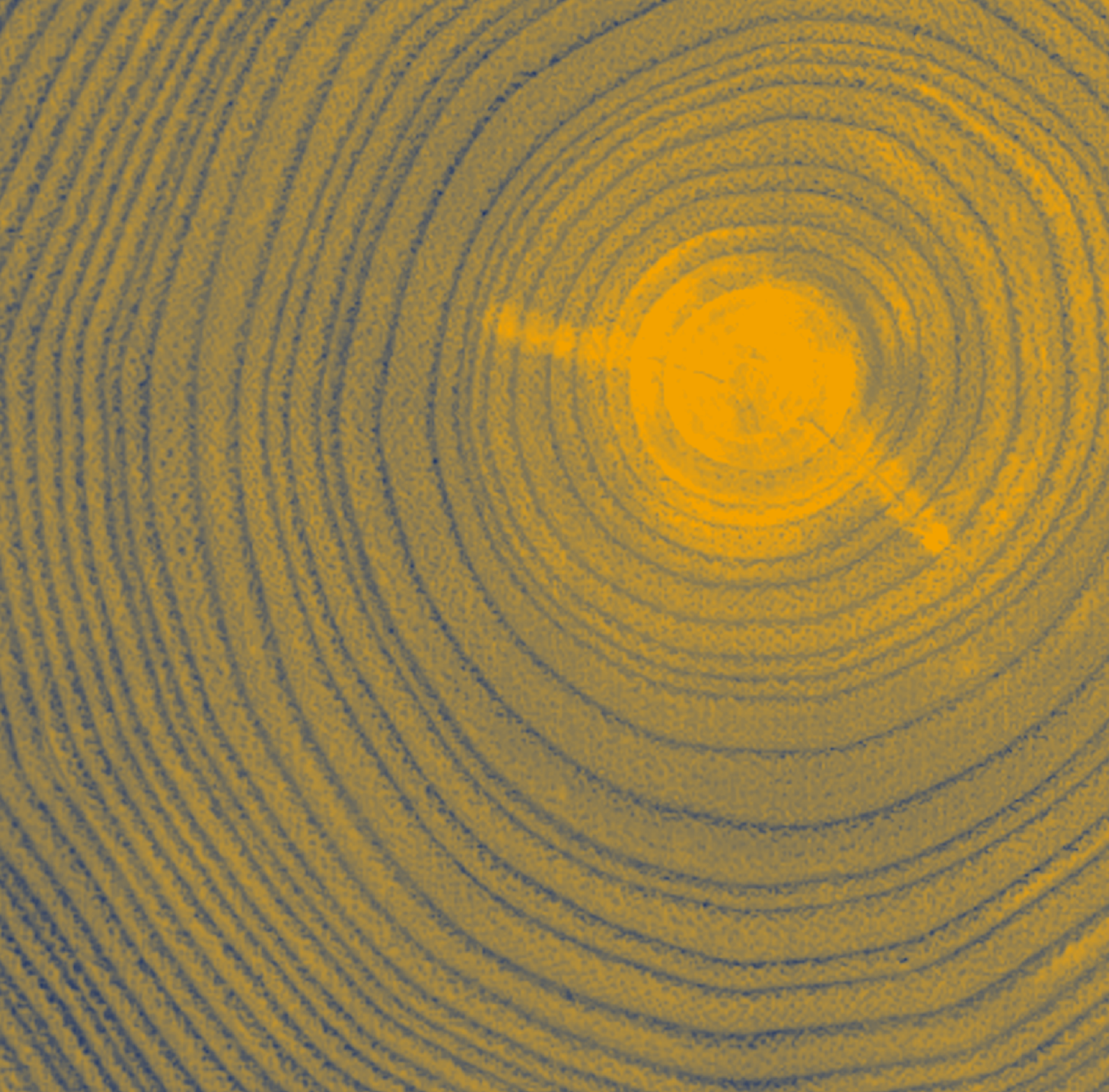
- 1.73 Board members, apart from the representative of the Minister for Finance, believe that the proposal for State retirement support should be pursued vigorously, because of the potential benefits to supplementary pension provision.

Related issues (Chapter 10)

- 1.74 A number of submissions to the NPR expressed continuing concern about the effect of the defined benefit funding standard. The Board recognises the importance of defined benefit schemes and that at present only members of such schemes appear to have a reasonable chance of achieving the NPPI adequacy targets.
- 1.75 Whilst it was not practical or appropriate for the NPR to revisit the review of the funding standard, the Board is aware of the concerns which have been expressed and will give consideration to whether it should recommend any further changes to the funding standard following completion of this Report.
- 1.76 The Board recognised the substantial potential benefits of a well designed pension protection system for defined benefit schemes. The Board intends to consider this issue further, taking account of practical and technical issues and of international experience.
- 1.77 There is increasing awareness of the potential costs of long-term care for those unable to look after their own day to day needs. As this is an issue that usually affects people in retirement, it is appropriate to consider how to relate it to pension policy and provision.
- 1.78 The Board has the following views:
- it is important to assess the impact of any decision about long-term care financing on pension provision and vice versa
 - the potential effect of any means-testing of long-term care benefits would be a cause of concern
 - there could be an adverse impact on attempts to increase pension coverage for women if there is continued reliance on women to provide informal care
 - personal savings are unlikely to be a significant component of financing long-term care
 - further development of a properly regulated equity release market with appropriate safeguards would be welcome.

Next steps

- 1.79 This Review has made a number of recommendations which are highlighted throughout the Report for consideration by the Minister for Social and Family Affairs. It is the view of the Board that many of the recommendations should be implemented with immediate effect, subject to Government approval and any required legislative changes.
- 1.80 The principal recommendations for immediate implementation are:
- The State incentive for PRSA personal contributions be granted by means of a matching contribution rather than through tax relief. These PRSA contributors should be allowed a limited access to their funds before the minimum retirement age of 60 (Section 7.42.1)
 - The State incentive for personal contributions to all other pension vehicles is granted at the higher rate either by the current method of relief at source or as a refundable tax credit (Section 7.42.2)
 - Point of sale regulation of Standard PRSAs be reduced (Section 7.42.3)
 - Incentives to encourage the proceeds of SSIsAs to be saved for retirement (Section 7.42.4)
 - Retirees to have the option to defer drawing first pillar pensions (Section 5.16)
- 1.81 The NPR includes as much analysis and research as was possible in the time available but there are some areas of the Report identified for further consideration and debate. They are listed below and readers are referred to the relevant sections in the Report:
- Monitoring EU-SILC relative poverty data (Section 3.13)
 - Review of progress towards the targets in 2008 (Section 3.19)
 - Further research on income related household data and non-pension wealth (Sections 3.19 and 4.14 - 4.16)
 - Development of pension coverage targets by broad employment sector (Section 3.20)
 - Research into the economic, social and cultural reasons why women's pension provision is lower than men's (Sections 4.24)
 - The projection of future pension costs at regular intervals as a basis for policy debate and formulation (Section 5.4)
 - The options to address the projected increasing cost of first pillar pensions (Section 5.22)
 - Automatic enrolment (Sections 7.36 – 7.39)
 - Further pensions awareness campaigns with particular emphasis on women and lower paid (Section 7.44)
 - Mandatory pension provision (Chapter 8)
 - State retirement support (Chapter 9)
 - Consideration of any further changes to the Funding Standard (Sections 10.2 – 10.4)
 - Further consideration of the issue of a pension protection fund (Section 10.5)



CHAPTER 2

BACKGROUND

CHAPTER 2 – BACKGROUND

NPPI Report

- 2.1 The National Pensions Policy Initiative ("NPPI") was initiated following the publication in 1996 of the Economic and Social Research Institute's ("ESRI") report entitled 'Occupational and Personal Pension Coverage 1995' prepared for the then Department of Social Welfare and the Pensions Board ("Board").
- 2.2 Stage 1 of NPPI involved the publication, in February 1997, of the NPPI Consultation Document issued by the then Department of Social Welfare and the Board. Following receipt of responses to the Consultation Document, Stage 2 involved the process of consideration leading, in May 1998, to the publication of the NPPI Report by the Board entitled 'Securing Retirement Income' ("NPPI Report").
- 2.3 The NPPI Report represented a comprehensive examination of national pensions provision and made a range of recommendations affecting the main elements of pensions policy for the future, covering both first and second pillars.
- 2.4 On 8 May 1998, the then Minister for Social, Community and Family Affairs responded, on behalf of the Government, to the main recommendations in the NPPI Report. At the same time as broadly accepting the recommendations, the response promised action to pursue and implement various specific proposals in the NPPI Report.

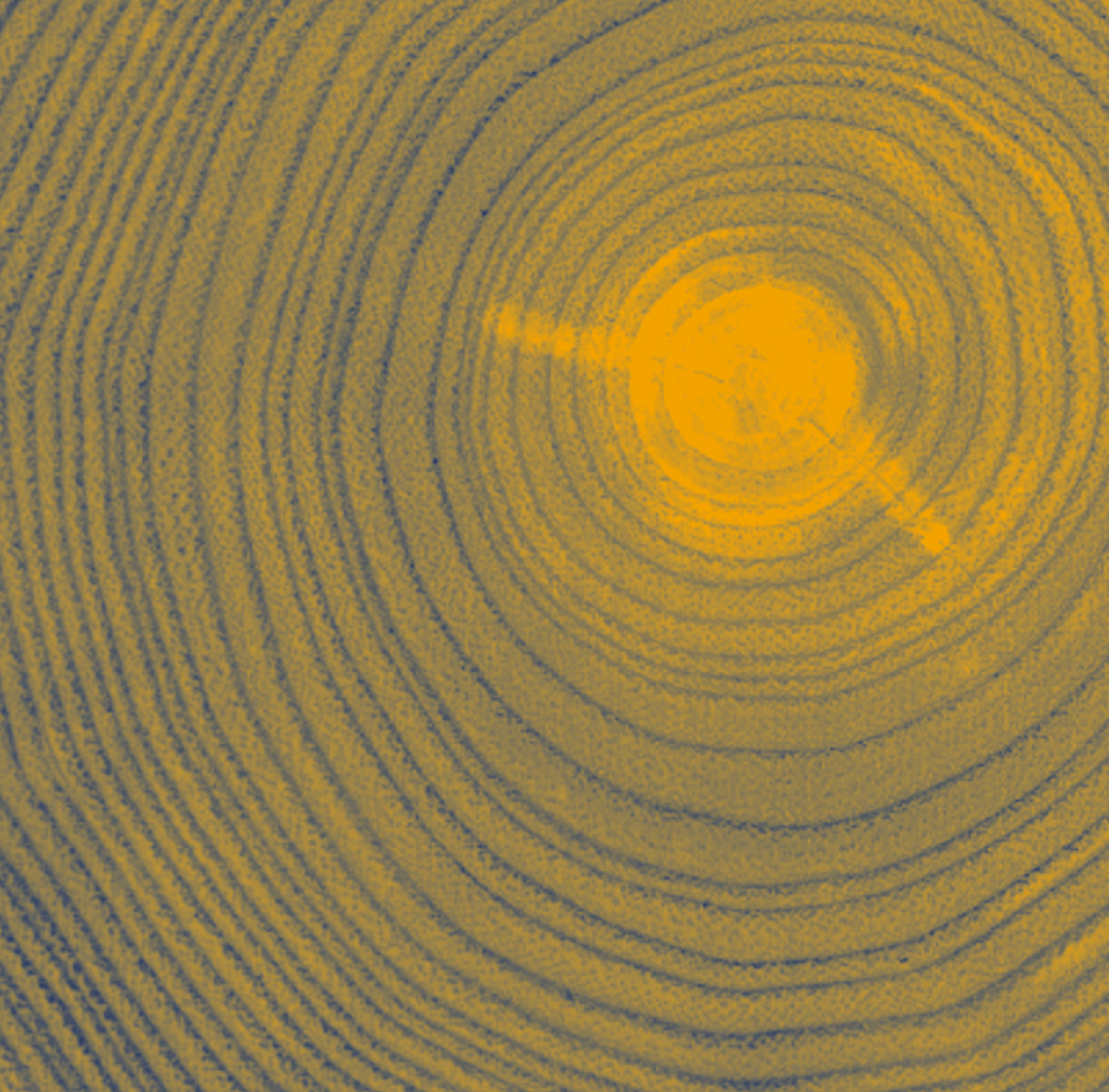
Subsequent Developments

- 2.5 In the years immediately following the NPPI Report and the Minister's response, a number of developments took place which implemented various essential recommendations in the NPPI Report. Amongst these developments were:
 - enactment of the National Pensions Reserve Fund Act, 2000, which established the National Pensions Reserve Fund ("NPRF")
 - enactment of the Pensions (Amendment) Act, 2002 (incorporating, inter alia, the statutory framework for Personal Retirement Savings Accounts ("PRSAs") and implementing the various NPPI recommendations on enhanced statutory protections for members of occupational pension schemes ("OPSS")) and subsequent implementation of almost all of its provisions
 - initiation of the National Pensions Awareness Campaign ("NPAC") (2003 and subsequent years)
 - agreement with the Central Statistics Office ("CSO") on a programme (commencing in 2002) to monitor second pillar coverage levels in the period up to 2006.
 - 2.6 Finally, as recommended in the NPPI Report, the Pensions (Amendment) Act, 2002 included a provision requiring a review of coverage, and associated issues, within a specified period after implementation of the employer mandatory access provisions of that Act.
- ### *Purpose of the present Review*
- 2.7 The purpose of the National Pensions Review ("NPR") is to review the current national pensions system with particular reference to the targets regarding coverage and adequacy of retirement provision.
 - 2.8 The review described in 2.6 above is provided for in Section 102(2) of the Pensions Act, 1990 (as amended) ("Pensions Act"), which requires a report on "the extent of the application of occupational and other pensions, in respect of such matters as the Minister considers relevant, to the population" to be prepared by September 2006.
 - 2.9 In February 2005, the present Minister wrote to the Board requesting the Board to undertake the statutory review during 2005, the review to examine alternative approaches to national pension provision and the report to contain proposals designed to "deliver on the commitment to ensure an adequate retirement income for all" (letter at Appendix 1).

- 2.10 The work of the Board under the NPR is being undertaken in order to respond to the Minister's request in accordance with Section 102(2) of the Pensions Act.
- 2.11 In responding to the Minister's request and welcoming the opportunity for it to be involved in the review, the Board (in February 2005) set out its view of the scope and main components of the NPR (document at Appendix 2). The Board considered that its proposed scope represented a major review covering the areas identified in the Minister's letter as well as incorporating the requirements of the statutory review.
- 2.12 The NPR does not include any review of the terms of public service pensions. For completeness, an estimate of the cost of these pensions is included in the assessments of the current and alternative systems (see Chapters 4 and 5), but the NPR does not draw any conclusions or make any recommendations.

Process

- 2.13 To assist in conducting the NPR, the Board, at an early stage, established a Steering Committee to oversee the review process. It also decided to:
- engage in a consultation process
 - arrange workshops, and
 - engage consultancy assistance.
- 2.14 The consultation process was initiated in early March by means of written invitations to a range of organisations/bodies with an involvement or interest in pension matters. At the same time, details of the NPR, with an invitation to make submissions, were placed on the Board's website. In total 36 submissions were received.
- 2.15 For the purpose of enhancing discussion and input on key aspects of the NPR, four workshops were organised over the period April to September, 2005. These were attended both by Board members and, apart from Workshop 4, a wider selection of invited participants. The output of these workshops was fed into the ongoing process of the NPR.
- 2.16 In order to assist the NPR, the following four consultancy assignments were commissioned:
- Pension Provision in Other Countries (Mercer Human Resource Consulting)
 - Benefit Options at Retirement (Hewitt Associates)
 - Possible State Involvement in Second Pillar Provision (Hewitt Associates)
 - Pension Systems Assessment (Life Strategies Limited/ESRI) ("LS/ESRI")
- 2.17 These four assignments, together with a report prepared for the Board in early 2005 by Indecon International Economic Consultants entitled 'Review of Potential Options to Encourage Increased Pension Coverage' ("Indecon Report"), contributed to the consideration process of the NPR. These are included in Appendices 4 to 8 of this Report.
- 2.18 During the NPR the Board made a comprehensive progress report to the Minister, by means of a presentation, on 29 June 2005.
- 2.19 The final substantive decisions and outcomes of the NPR were completed at formal Board meetings on 24 and 26 October, 2005.



CHAPTER 3

REVIEW OF NPPI TARGETS

CHAPTER 3 – REVIEW OF NPPI TARGETS

- 3.1 The NPPI Report recommended targets for first pillar (i.e. Old Age Contributory Pension (“OACP”) and for replacement income. In summary, they are:

- A target replacement income of 50% of pre-retirement income before tax; and
- An overriding minimum income of 34% of Gross Average Industrial Earnings (“GAIE”).

The NPPI Report also concluded that in order to achieve the replacement income target, supplementary pension coverage would be needed for 70% of the working population aged over 30.

In the light of what is seen to be slow progress towards the supplementary coverage and replacement income targets, and possible initiatives to reinforce progress, it is appropriate to consider whether these targets are still suitable, despite the relatively short time in pension terms that has elapsed since they were set out in the NPPI Report.

Replacement income target

- 3.2 The NPPI Report set a replacement income target of 50% of gross pre-retirement income, subject to a minimum income as described below. The background to this recommendation was set out in section 5.1.7 of the NPPI Report, and readers are referred to that document.

The NPPI recommendation was made in the context of sparse data on aggregate household wealth, and, possibly more importantly, about the distribution of such wealth. Since the NPPI Report was published in 1998, little further information has become available.

- 3.3 The Board, with the exception of the representative of the Minister for Finance, is still of the view that the NPPI replacement income target of 50% of gross pre-retirement earnings remains the appropriate one to secure income adequacy in retirement. This target is of especial relevance to lower income groups who are unlikely to have significant non-pension assets upon which to draw in retirement.

The representative of the Minister for Finance considers that, in the light of the absence of agreed methodologies for measuring progress, serious difficulties have been, and will continue to be, encountered in ascertaining the adequacy of income replacement. In addition, under a voluntary system of supplementary pension provision, the attainment in retirement of set percentages of pre-retirement income will be, for the majority, the product of individual choice. Consequently, the representative’s view is that the Government, while it might take action to incentivise pension take-up, cannot be held responsible for the degree to which individuals choose to react to incentives. In the circumstances, he believes that it is inappropriate that a “target” be set in this area; rather, 50% income replacement can only be regarded as an aspiration.

Target rate for first pillar pension

Background

- 3.4 The NPPI Report proposed a target rate of 34% of the previous year’s GAIE for the OACP, to be achieved over a 5 to 10 year period. This target was suggested against the background of a post-Budget 1998 pension of 26%, based on GAIE for 1997, and a Government commitment to achieving a minimum rate for pensions of €127 per week by 2002. The 2005 OACP of €179.30 per week represents 32.0% of 2004 GAIE of €560.77 and 30.5% of estimated 2005 GAIE.

It should be noted that the 34% target was not adopted by the Government as a policy. However, the Government has since set a target of OACP of €200 per week by 2007.

Overview

- 3.5 The purpose of the following sections is to set out the origins of the first pillar target rate suggested in the NPPI Report and to assess its suitability as an ongoing target for pensions. The original NPPI minimum income target was arrived at mainly (but not exclusively) after consideration of measures of poverty and the income that would be necessary to avoid such poverty. At the time of the NPPI Report, there was comparatively little information available on relative poverty. However, since then, considerably more data have become available, and this measure is of increasing importance, particularly in EU comparisons.

Reports on Adequacy of Social Welfare Rates

- 3.6 Various studies have been undertaken over the last 20 years to try and set target rates for Social Welfare payments. The following is a short summary of the conclusions of these various reports:

■ Commission on Social Welfare (1986)

The Commission on Social Welfare ("the Commission") was concerned to ensure that Social Welfare payments "offer an adequate standard of living to Social Welfare recipients whatever their household circumstances and independent of any other income sources accruing to individuals or households." In arriving at a target rate for payments the Commission intended to "establish a level of income which would be sufficient to maintain a single adult in independent circumstances where there is no additional source of income, at a standard which is linked to living standards in society generally".

In assessing an appropriate payment rate, the Commission used seven different methods. The methods used were quite varied and were based on such things as the cost of a minimum adequate diet and the percentage of overall income spent on food, the cost of maintaining a person in an institution, payments based on average earnings, incomes allowed for means testing services such as medical cards, tax, minimum wage rates allowed under Joint Labour Committees etc.

In arriving at a range of recommended payments, the Commission acknowledged that there was "no universally accepted method for deriving a minimum income". It recommended that a basic payment in the range €63 to €76 per week (i.e. £50 to £60), which was 17% to 21% of 1986 GAIE. The higher end of the range was based on an assessment related to personal income/minimum earnings which would be minimally adequate for the lowest Social Welfare payments. The difference between these payments and the highest Social Welfare payments (i.e. OACP) would be about 10%, i.e. 19% to 23% of 1986 GAIE.

■ A review of the Commission on Social Welfare's minimum adequate income, ESRI (1996)

In 1996, the ESRI was commissioned by the Department of Social Welfare to review the recommendations of the Commission in relation to minimum payments rates. The ESRI reviewed five of the methods applied by the Commission and also looked at the issue from a number of other perspectives. However, like the Commission, the ESRI stressed that the various approaches applied do not "allow one to derive in an unproblematic, objective, and scientific way estimates of income adequacy which would be universally acceptable and convincing".

The estimates of minimum adequate income levels produced by the ESRI in 1996 for a single adult ranged from approx €86 to €122 per week (i.e. 24% to 34% of 1996 GAIE).

■ *National Pensions Policy Initiative (1998)*

The adequacy of Social Welfare pensions was considered in the context of the NPPI with a view to setting a target rate for the OACP. In considering an appropriate rate the work of the Commission and the ESRI was considered. In adopting a target rate the Board was concerned to minimise the risk of poverty and to provide coverage to lower income people in the most efficient way. In relation to the latter, the Board was conscious of the relatively high costs of funding and administering small pensions.

Accordingly the Board decided to suggest a weekly target of €122 per week for the OACP based on the conclusions of the ESRI report outlined above. For reasons of practicality, the Board considered that this should be expressed as a percentage of GAIE which at that time equated to about 34%. The Board saw the target being reached over a 5 to 10 year period.

■ *Benchmarking and Indexation Group (2001)*

This group was established under the Programme for Prosperity and Fairness to examine the range of complex issues associated with benchmarking and indexation of Social Welfare payments. The majority of the group considered that a target of 27% of GAIE for the lowest Social Welfare payments was not an unreasonable policy objective; a minority favoured 30% while others considered it inappropriate to set a target given that it was ultimately up to the Government to determine the level of Social Welfare increases from year to year. Traditionally, the OACP would have been well ahead of minimum welfare rates, and the group was mindful of the NPPI OACP target of 34% of GAIE.

3.7 Table 3.1 below compares the OACP with GAIE since 1998.

Table 3.1 – comparison of average industrial earnings with OACP (€ per week)

	1998 € p.w.	2005 € p.w.	% increase 98/05
OACP	95.23	179.30	88%
GAIE (previous year)	371.51	560.77	51%
OACP as % of GAIE (previous year)	26%	32%	
GAIE (current year)	387.56	588.81 (est.)	52%
OACP as % of GAIE (current year)	25%	30%	

This table shows clear progress towards the NPPI targets, and significant real increases in the OACP. The results of this progress are shown in the statistics for consistent poverty among those aged over 65. The data in table 3.2 are taken from the ESRI's Living in Ireland Survey ("LIIS"), and show the percentage of men and women over 65 below 70% of median income experiencing basic deprivation.

Table 3.2 – percentage over 65 below 70% of median income experiencing basic deprivation

	Men	Women
1997	6.1%	10.2%
2001	3.1%	4.4%

Relative poverty

3.8 Relative poverty attempts to measure poverty by reference to the income of others rather than by an absolute measure of what income is required. Probably the most common measure of relative poverty is the risk-of-poverty line, which is often presented as 60% of the equivalised (i.e. adjusted for family size) median household income.

This section looks at income and poverty data from 1994 to 2003 (the latest available data at the time of writing). Data are taken from the LIIS from 1994 and 2001; this survey has been replaced as the main national source of income and poverty data by the EU Survey of Income and Living Conditions (EU-SILC) from 2003 onwards.

In the following tables 'risk' is defined as the percentage of households of that type falling below the poverty line. For instance, in the first line of table 3.3 below, in 1994 3.2% of households where the reference person was at work had income below the defined poverty level.

'Incidence' is the proportion of all households below the poverty level represented by households of that type. Again on the first line of table 3.3, in 1994 8.3% of all households in poverty were those where the reference person was at work.

Table 3.3 – risk and incidence of relative income poverty for household types

	1994		2001		2003	
	Risk %	Incidence %	Risk %	Incidence %	Risk %	Incidence %
Employee/at work	3.2	8.3	8.1	18.8		
Self-employed/farmer	16.0-18.6	20.7	14.3-23.0	14.2	9.2	n/a
Unemployed	51.4	41.1	44.7	7.3	42.1	n/a
Ill/disabled	29.5	6.2	66.5	11.9	54.0	n/a
Retired	8.2	6.0	36.9	18.8	31.0	n/a
Home duties	20.9	20.9	46.9	29.0	37.0	n/a
All	15.6	100.0	20.9	100.0	22.7	100.0

Note that the above analysis is based on the percentage of individuals in each category living with a household reference person/head of household at work, unemployed, etc. Incidence data for 2003 are not available.

Table 3.3 shows that the proportion of all households in relative poverty increased from 15.6% in 1994 to 20.9% in 2001 and increased further to 22.7% in 2003. Of these households classified as in poverty, the percentage classified as unemployed fell dramatically between 1994 and 2001 from 41.1% to 7.3%. This reflects the reduction in total unemployment over the period. Although the risk of poverty in such households reduced somewhat, it was the reduction in the number of unemployed households that caused almost all of the fall in incidence. Most other categories of household showed an increase both in the risk and incidence of relative poverty between 1994 and 2001, but the greatest increase was in 'retired' households, despite the increases in OACP shown in table 3.1.

Table 3.4 compares changes in household income with changes in earnings and OACP between 1994 and 2003 (i.e. the same period as the relative poverty data in table 3.3 above):

Table 3.4 – comparison of earnings, OACP and household income (€ per week)

	1994	1997	2003	% increase 94/03
GAIE (previous year)	327.60	360.11	501.51	53%
OACP	90.15	99.04	157.30	74%
Median equivalised household income	138.96	170.74	308.8	122%
Risk-of-poverty line (60% of median income)	83.38	102.44	185.28	122%
Consumer price index (end of year, rebased)	100	106	132	32%

This table clearly shows that, although GAIE increased by more than prices (53% versus 32%) and the OACP increased by more than GAIE (74% versus 53%), the 122% increase in the risk-of-poverty line is considerably higher.

This pattern can be placed in the context of the social partnership process of the period. Moderation in wage increases was facilitated by tax concessions, and the interaction of these two effects created a third dynamic of increased employment. People on Social Welfare incomes throughout the period largely received the benefit of real increases (although formal indexation of Social Welfare rates to earnings growth did not apply), but did not benefit significantly from tax reforms or improvements in the labour market.

Some of the extra employment was taken up by people who were previously unemployed. However, a significant proportion was taken up by people who were in households most likely to be already above the risk-of-poverty line. The increase in female participation in paid employment over the period largely falls in this category: between 1994 and 2003, the female employment rate increased from 40% to 55%. This has the effect of increasing the risk-of-poverty line relative to those on Social Welfare incomes.

Changes in taxation over the period had an additional impact. Household incomes in the above statistics are shown net of tax. However, the tax reductions over the period primarily benefited those in employment rather than those on Social Welfare incomes. For instance, the tax on GAIE fell from 32% in 1994 to 17% in 2003. The result would have been to further increase the risk-of-poverty level relative to those on Social Welfare incomes.

3.9 The older population can be further analysed to show how specific household types fare relative to the risk-of-poverty line. Table 3.5 below shows the equivalised income for a number of different household types as follows:

- A pensioner couple receiving OACP plus a Qualified Adult Allowance ("QAA") – shown as OACP + QAA
- A pensioner couple receiving two OACPs – shown as 2 OACP
- A single pensioner receiving the OACP plus a Living Alone Allowance – shown as OACP + LAA

(Equivalised income is household income adjusted for the number of people in the household: it is calculated by dividing the total household income by an adjusted number reflecting the number of people – 1 for the first adult, 0.66 for the next adult, etc. Thus, for instance, if there are two adults only, the total household income is divided by 1.66).

The table shows that for instance in 1994, OACP + QAA received a total pension of €154.91 per week. This is equivalised by dividing by 1.66, which equals €93.32. This was €9.94 more than the 1994 risk-of-poverty income of €83.38.

Table 3.5 – Selected Social Welfare household incomes compared to 60% median income poverty line

	1994 €	1997 €	2001 €	% rise 1997- 2001	2003 (EU-SILC) €	2003 NPPI rec.* €
Risk of poverty line (60%)	83.38	102.44	164.28	97.0%	185.28	185.28
2 person pensioner households						
OACP + QAA aged over 65	154.91	169.38	235.66	52.1%	278.80	314.51
Equivalised income	93.32	102.04	141.96		167.95	189.47
Income gap	9.94	-0.40	-22.32		-17.33	4.19
2 OACP pensioners	180.30	198.08	269.18	49.3%	314.60	341.03
Equivalised income	108.61	119.33	162.16		189.52	205.44
Income gap	25.23	16.89	-2.12		4.24	20.16
1 person pensioner household						
OACP + LAA	96.24	106.66	142.21	47.8%	165.00	178.21
Equivalised income	96.24	106.66	142.21		165.00	178.21
Income gap	12.87	4.22	-22.07		-20.28	-7.07

Source : EU SILC and LIIS

* OACP set at 34% of 2002 GAIE (NPPI recommendation) and QAA equal to the Old-Age Non-Contributory Pension ("OANCP")

The table shows that for the two-person pensioner households, only the household receiving two full OACPs (shown as 2 OACP) was above the risk-of-poverty line in 2003. Increased female participation in paid employment makes this the most likely outcome for pensioner couples in the long-term. This household type has benefited most in overall cash terms from the rise in separate individual rates. If implemented fully, the NPPI recommendation of raising OACP to 34% of GAIE would have moved the household further above the risk-of-poverty line. The pensioner couple with a qualified adult (shown as OACP+QAA in the table) has fallen below the risk-of-poverty line, but this trend can be expected to reverse when the commitment in the Programme for Government to increase QAA rates to the level of the OANCP rate is implemented (in tandem with the NPPI recommendation).

Pensioners living alone have fallen below the risk-of-poverty line over the period: the NPPI recommendation would still leave this group around the level of the risk-of-poverty line in 2001 and 2003. Reaching the NPPI recommendation of 34% of GAIE would not, of itself, have made a decisive impact on risk-of-poverty levels for people living alone on OACP.

- 3.10 The risk-of-poverty data clearly raises the question of whether the original NPPI first pillar target is appropriate. The answer to this cannot be separated from issues of sustainability which are considered in later sections. In considering whether household incomes and the risk-of-poverty line would be a suitable benchmark for contributory pensions, the Board considered the following issues:

- The rapid movement in the 60% risk-of-poverty line over the period 1994-2001 would have made it a difficult benchmark for Social Welfare incomes. This movement was a result of significant societal and economic change over the period, and annual rises in Social Welfare payments in line with household incomes would have been difficult to sustain. However, there is some evidence that since 2003 household incomes may now be increasing at a more moderate pace relative to earnings, which would be consistent with tax and employment developments in recent years. The relationship between household incomes and changes in earnings, taxes and the labour market needs to be monitored on an ongoing basis
- If the Irish unemployment rate were to increase, the median household income might fall, which would require matched pensions to fall also. This would not be acceptable
- Tax changes could also have unintended consequences for matched pensions. Tax bands have not always been fully indexed in line with earnings, which results in 'fiscal drag' and higher average tax rates under the marginal tax system. Were first pillar pensions indexed to net household incomes, this could result in first pillar pensions rising at a lower rate than GAIE, which would also be an unacceptable policy outcome
- At a practical level, there is a longer time delay for availability of household incomes data than for GAIE for monitoring purposes, though significant improvements in timeliness are expected in future with EU-SILC.

3.11 The view of the Board is that first pillar pension targets should continue to use GAIE as a reference, as the median household income is too volatile year on year; however, this should be kept under review.

3.12 The Board with the exception of the representative of the Minister for Finance, accepts 34% of GAIE as a minimum target for OACP as proposed in the NPPI Report. The Board notes that this target has not been officially accepted by Government, and will require considerable additional State resources to achieve as the OACP rate is currently at 32% of GAIE. However, the Board also notes the Government's commitment to OACP of €200 per week by 2007. Indexation of first pillar pensions in line with earnings has not been accepted as Government policy, although in practice, since the NPPI Report, first pillar pension rates have increased more quickly than GAIE.

3.13 The increase in real incomes over the period between the NPPI and the NPR has resulted in a dramatic improvement in living standards for older people, as can be seen in the improvement in consistent poverty between 1994 and 2001, and consistent poverty rates in 2003 for older people are still lower than for the population as a whole. However, the income surveys show a disimprovement in the income position of older people compared to those of working age over the period between the NPPI and the NPR. While issues such as housing costs and availability of the free schemes affect cross sectional comparisons of both groups, it is less certain that the relative situation of the two groups over time would have been influenced by these factors.

While the data for relative incomes supported the 34% of GAIE target at the time of the NPPI Report (only 1994 income data were available at that time, and this information was also central to the ESRI's estimate for minimum income), this relationship does not hold for the more current incomes data. Also, under the EU's Open Method of Co-ordination for Adequate and Sustainable Pensions, income adequacy continues to be measured based on relative income measures. For these reasons, the representative of the Minister for Social and Family Affairs has pointed out that a higher minimum pension target would be needed to ensure that the proposed 30% of pensioners without supplementary pensions have an adequate income by reference to household incomes generally. Based on 2003 data, the higher OACP target would be 36% of GAIE based on national equivalence scales and income definitions or 40% of GAIE based on the criteria used for EU poverty monitoring. However, the 2003 income data were the first results from EU-SILC, and the definition of income used in the survey is still being developed, so survey results will need to be closely monitored over the next few years to ensure that the target rates remain appropriate.

A number of other members of the Board also support an increase in the basic income target. Furthermore, some of these have expressed the view that if a mandatory system is not introduced, the first pillar benefit should be increased to some extent because the supplementary coverage levels are likely to be lower and as a result, there will be a continuing risk of poverty among pensioners.

Some members also support an increase in first pillar pensions to a level above 34% of GAIE as a means of distributing current economic benefits more widely, including to those no longer in the workforce.

Second pillar coverage target

- 3.14 Having accepted targets for post-retirement income and for first pillar pensions, it is necessary to estimate what proportion of the population will require supplementary coverage in order to achieve the income target.
- 3.15 In the NPPI Report, the numbers requiring supplementary provision were estimated by comparing population income distribution (derived from Pay Related Social Insurance ("PRSI") data for the 1995/1996 tax year) with the target first pillar pension. This would show what proportion of the population would achieve a 50% replacement income from the (target) first pillar, and what proportion would require supplementary coverage. Table 3.6 below shows the results of this comparison:

Table 3.6 – comparison of minimum income target with 1996 earnings data (€ p.a.)

Decile	Average income €	Target minimum €	Minimum/average
1	7,721	6,367	82%
2	10,185	6,367	63%
3	13,054	6,367	49%
4	14,285	6,367	45%
5	16,965	6,367	38%
6	18,961	6,367	34%
7	21,960	6,367	29%
8	26,604	6,367	24%
9	31,363	6,367	20%
10	50,148	6,367	13%

The table shows that by the third decile, the target first pillar income would provide less than 50% of pre-retirement income, i.e. supplementary provision would be needed in order to meet the objective of a 50% replacement income. About 70% of the population would therefore require some degree of supplementary provision to achieve the income target.

- 3.16 The most recently available PRSI data (from 2003) are compared with the minimum income target for that year in table 3.7:

Table 3.7 – comparison of minimum income target with 2003 earnings data (€)

Decile	Average income €	Target minimum €	Minimum/average
1	11,541	9,490	82%
2	15,083	9,490	63%
3	18,489	9,490	51%
4	21,699	9,490	44%
5	25,010	9,490	38%
6	28,671	9,490	33%
7	33,164	9,490	29%
8	38,897	9,490	24%
9	47,623	9,490	20%
10	84,170	9,490	11%

The table shows that by the third decile, average income is slightly less than twice the first pillar pension. Following the methodology of the NPPI Report, it is clear that the numbers who will require supplementary provision to achieve the target retirement income is still about 70%, i.e. everyone on the fourth and higher deciles.

- 3.17 Having estimated the numbers who will need supplementary provision to achieve the replacement income targets, it is then necessary to translate this into targets for coverage levels. Coverage targets allow the Board and all other interested groups to assess progress and to consider what action, if any, might be appropriate if the targets are not being met.

The NPPI Report set a primary target of 70% coverage for those aged over 30. In setting the target, the NPPI Report recognised that coverage would include some in the first three deciles, and that this would offset the fact that a target of 100% of those in the higher deciles would not be appropriate.

- 3.18 A coverage target must take account of a number of factors:

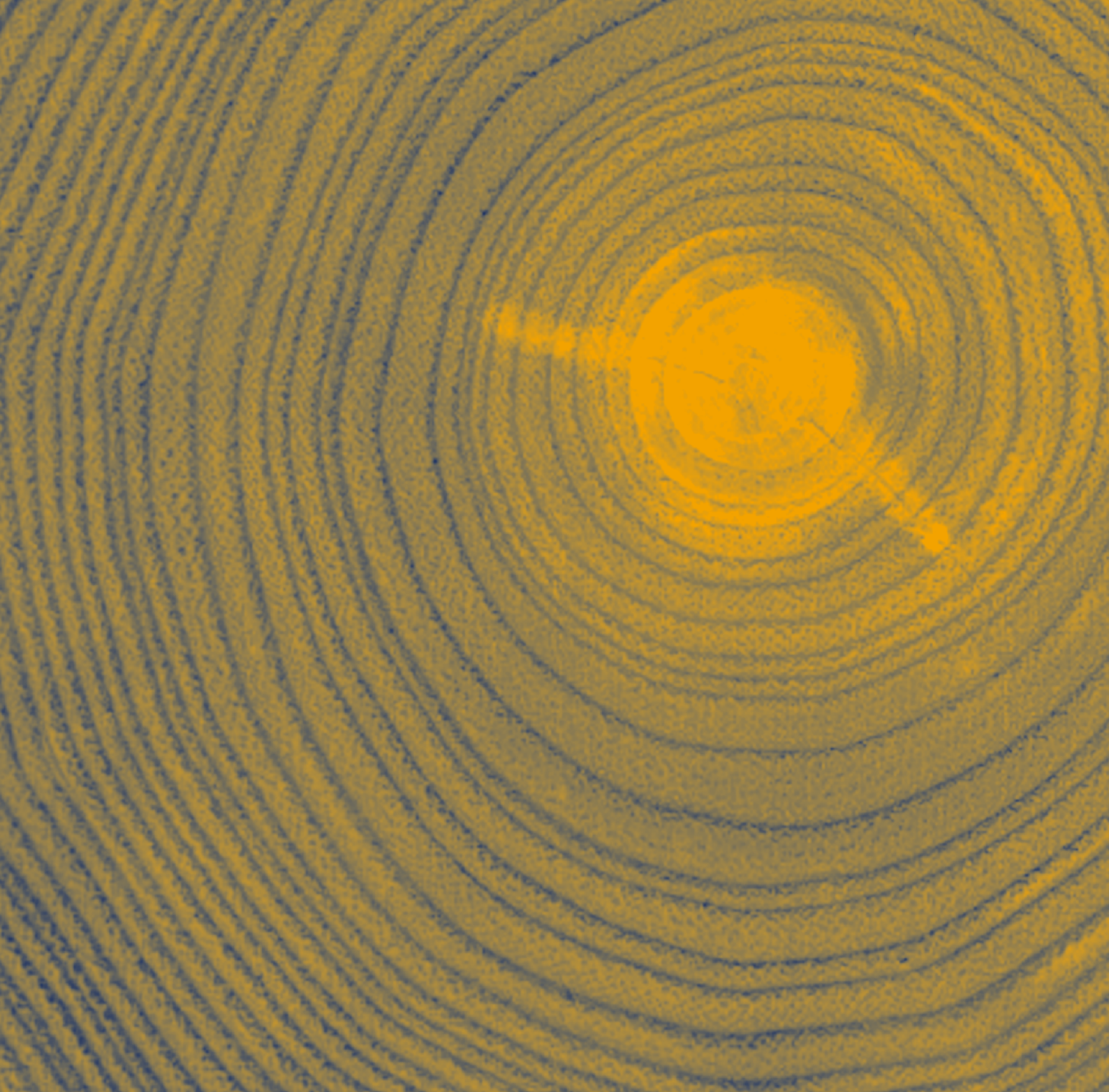
- The target must be measurable: although the Board's primary concern is pension coverage for those on lower incomes, there are no reliable data available for pension coverage of different income or wealth groups
- The target must be defined within an unambiguous timeframe: the original NPPI targets were set by reference to the implementation of the major recommendations of the NPPI Report, but there is no common understanding of what that implementation date was.

- 3.19 The Board accepts the continuation of the NPPI ultimate coverage target of 70% of those working who are aged over 30. This is an ultimate target, to be achieved in the period after 2013, and is to take account of such factors as structural changes in the labour force over time. The Board is of the view that the base date for measuring progress against interim targets should be September 2003, which is the date on which employer PRSA obligations came into force.

The Board recognises the drawbacks of a single figure measure of coverage. The greatest obstacle to a more precise coverage target is the unavailability of pension coverage data by income level. The Board is well aware of the practical difficulty of getting reliable regular data of this type. Nonetheless, the Board believes that these data are essential for precise assessment of pension policy progress.

Close attention must be paid to the progress towards the targets, and the Board intends to explore with the CSO and other State agencies what further information can be gathered to allow pension coverage to be measured in a more precise and useful way and to put in place appropriate interim and subsidiary coverage targets. The Board recommends a further review of progress in 2008.

- 3.20 There are a number of employment sectors where pension coverage is of especial concern. Therefore, even in the absence of income and pension data, useful information on progress can be provided by an analysis of pension coverage by employment sector. The Board intends, after further analysis of pension and employment data, and after discussion with the CSO of the issues of measuring coverage, to set coverage targets for a number of broad employment sectors.



CHAPTER 4

REVIEW OF CURRENT COVERAGE AND ADEQUACY

CHAPTER 4 – REVIEW OF CURRENT COVERAGE AND ADEQUACY

- 4.1 In his letter to the Board of 3 February 2005, the Minister for Social and Family Affairs mentioned the disappointing level of coverage as a reason for bringing forward the 2006 statutory review of coverage as required under Section 102(2) of the Pensions Act. It therefore seems appropriate to examine both the current level of coverage and the rate of progress towards the NPPI coverage targets.

First pillar coverage

- 4.2 The NPPI Report set no targets for OACP coverage, because earlier policy had been to draw almost the entire working population into Social Insurance, and during the previous decade, this had largely been achieved. Anyone aged over 65 who is not entitled to an OACP is entitled, subject to a means test, to the OANCP.
- 4.3 Since 1998, the proportion of pensioners receiving an OACP has increased from 61% to 71% in 2004 and is projected to increase to 98% by 2056. However, the issue of means testing for the OANCP should be kept under review, as should the qualifying conditions for the OACP, and the relationship between them. Otherwise, people on very low supplementary pensions could find themselves at risk of poverty if they do not meet the qualification conditions for the OACP and are disqualified from the OANCP because of their supplementary pension.

Supplementary coverage

- 4.4 The primary target for coverage set in the NPPI Report is that 70% of those in work (including the self-employed) aged over 30 have supplementary pension provision. There were also a number of supplementary targets, and all the targets are set out in table 5.1 on page 93 of the NPPI Report, which is reproduced here as table 4.1.

Table 4.1 – NPPI coverage targets

				1995 %	5 years %	10 years %	Ultimate %
All at work				46	53	57	60
Of which	All workers	<30		28	34	35	35
		30-65		54	62	66	70
		Self-employed		27	36	43	44
	Employees		51	58	61	64	
		- public service		83	90	90	90
		- private sector		38	48	53	58
Men				49	54	58	59
Of which	self employed	<30		24	28	32	32
		30-65		29	38	45	45
	employees	<30		29	35	35	35
		30-65		73	75	75	75
Women				40	51	56	61
Of which	self employed	<30		1	16	32	32
		30-65		20	33	40	45
	employees	<30		29	35	35	35
		30-65		54	65	70	75

The NPPI Report set higher ultimate coverage targets for women than for men as it was felt that women are less likely to have non-pension savings, and therefore are more likely to depend on supplementary pensions.

4.5 In reviewing progress to date, there are a number of issues to be considered:

- The primary NPPI recommendations on coverage (i.e. introduction of PRSAs, mandatory access to PRSAs or OPSs for employees and the National Pensions Awareness strategy) were implemented in 2003. There have only been two years in which to measure progress towards the targets which is not sufficient to provide unambiguous statistical evidence
- Changes to and the rate of change in the composition of the Irish workforce since the mid-1990s mean that the assessment of progress and the continuing validity of the original interim targets are not straightforward
- At the time of writing, the only data available to measure progress are CSO figures for 2002 and 2004. Corresponding figures for 2005 will become available shortly.

4.6 The 2002 CSO Quarterly National Household Survey ("QNHS") included a pension module. The purpose of this module was to set a benchmark to assess subsequent progress or otherwise in achieving the NPPI targets from the implementation of the Pensions (Amendment) Act, 2002. Table 4.2 compares the main coverage data from this survey with the data in the NPPI Report (taken from the ESRI Survey of Occupational and Personal Pensions Coverage, 1995) and with the NPPI ultimate targets.

Table 4.2 – comparison of opening position with NPPI targets

		1995 ESRI	2002 CSO	NPPI ultimate target
Pension coverage – all workforce		46%	51%	60%
Pension coverage	Age less than 30	28%	36%	35%
	30 to 65	54%	58%	70%
Pension coverage	Men	49%	56%	59%
	Women	40%	45%	61%
Pension coverage	Self-employed	27%	44%	44%
	Employees	51%	53%	64%

It is important to note that the 1995 figures in the NPPI Report were taken from the ESRI Survey of Occupational and Personal Pensions Coverage, 1995. The data and methodology differ from the CSO QNHS data. However, the differences in the results between 1995 and 2002 are not felt to be significant, and the Board's focus is on changes since the 2002 CSO QNHS survey.

- 4.7 The Board does not believe that the differences between the 2002 and 1995 figures would justify any change to the primary coverage target of 70%, though some adjustment of the subsidiary targets may be appropriate.
- 4.8 The QNHS pension data are of significant importance to Irish pension policy and the Board appreciates the important work of the CSO in this regard. It is important that this information continues to be collected on a consistent basis. The Board recognises the challenges posed in gathering this data as pensions are

not a subject with which many people are very familiar, even where they do have pension arrangements in place. As a result, the Board is aware that there may unavoidably be small variations in the data between successive surveys, and therefore it is the trend in coverage that should be considered rather than small changes in coverage percentages. Measurement of adequacy is even more difficult, and this is discussed further below.

- 4.9 The CSO included a further QNHS pensions module in 2004, which allowed progress to date to be measured on a comparable basis. Table 4.3 compares the 2004 results with the 2002 results, and with the NPPI five year targets and with the NPPI ultimate targets.

Table 4.3 – comparison of progress with NPPI targets

		2002 CSO survey	2004 CSO survey	NPPI 5 yr. target	NPPI ultimate target
Pension coverage – all workforce		51%	52%	53%	60%
Pension coverage	Aged less than 30	36%	35%	34%	35%
	30 to 65	58%	59%	62%	70%
Pension coverage	Men	56%	56%	54%	59%
	Women	45%	47%	51%	61%
Pension coverage	Self-employed	44%	43%	36%	44%
	Employees	53%	54%	58%	64%

Note that the NPPI targets for 5 (and 10) years were intended to be five years/ten years after the implementation of the NPPI Report recommendations, and so can be considered to be the targets for respectively 2008 and 2013, measured from the implementation in 2003 of the provisions of the Pensions (Amendment) Act, 2002. The ultimate targets are therefore to be achieved in the post 2013 period.

The headline coverage figure for those over 30 increased from 58% to 59%, which is consistent with progress on the timescale envisaged in the NPPI Report. The subsidiary coverage measures have mostly increased consistently – the slight fall in self-employed coverage is probably within the range of likely variation from survey to survey.

- 4.10 When examining the coverage figures, especially the interim targets, it is important to be aware of the changes to the workforce since the original coverage targets were set. Included in the NPPI Report was a projection of the workforce for 10 years from 1995. This can be compared with the actual data for the last 10 years and with the recently published projections issued by the CSO.

Table 4.4 – comparison of NPPI workforce projections with recent data (000s)

	1995	2000	2005	2010	2016
NPPI/ESRI projections	1,186	1,525	1,640	-	-
Actual CSO data	1,186	1,700	2,000	-	-
CSO 2005 projections	-	-	-	2,200	2,400

The numbers in the workforce are now considerably higher than was anticipated in the 1990s. This means that the absolute number of people that must have supplementary pension provision in order to meet the percentage coverage targets is much greater than anticipated.

Similarly, the number of people already with coverage is much greater than was projected. Table 4.5 compares the original targets with progress to date measured by the number of people with supplementary pension provision rather than the percentages.

Table 4.5 – comparison of numbers with supplementary pension provision (000s)

	ESRI	NPPI targets		CSO QNHS	
	1995	2008	2013	2002	2004
Numbers with supplementary pension provision	543	813	934	938	998

The total numbers covered in 2004 were greater than was projected for a date 10 years after the implementation of the NPPI coverage strategy, although this implementation was not substantially completed until 2003.

- 4.11 It is likely that the absolute increase in the numbers in the workforce since 1995 has made the percentage coverage lower than it would otherwise have been. Those who have recently joined the workforce are less likely than others in the short-term to voluntarily consider pensions coverage: this is likely to be especially true for those working part-time.

The substantial increase in the numbers in the workforce may mean that the interim targets are not appropriate. However, the increase should not affect the ultimate targets: the same proportion of those currently in the workforce will need a replacement retirement income if they are to avoid poverty.

- 4.12 It is worth considering what the coverage would have been had the workforce increased as expected. For instance, in 2004, the workforce was approximately 300,000 higher than expected under NPPI. If we assume that the rate of pension coverage of these 'additional' workers is half the average, then the effect of the increase was to reduce the coverage level to 52.4% from what might otherwise have been about 57%. This illustrates how sensitive the coverage levels are to changes in the composition of the workforce, and how difficult it is to draw definitive statistical conclusions with only two years' experience.
- 4.13 There is no significant change in the pattern of coverage since the 1995 statistics. From this information and from other sources it is possible to conclude that coverage continues to depend on age, income, and size of employer. Furthermore, women are less likely to have coverage than men, even after allowing for the above differences. These differences are reflected in the coverage levels for different occupations, which in turn reflect the age, income and gender composition of the workforce.

Other savings

- 4.14 The NPPI Report concluded that the OACP would not provide the target replacement income (i.e. 50% of pre-retirement income) for 70% of the workforce, and therefore that this proportion would require supplementary retirement provision. At that time it was assumed that this provision would be through second pillar pensions.

A number of submissions received as part of the NPR have referred to savings outside the pensions system (third pillar savings). These submissions have suggested that such savings comprise a significant additional means of retirement provision, and in particular that property investment comprises an important new factor to be taken into account. The implication of this would be that the measurement of supplementary pension provision may be understating the extent to which people are saving for their retirement.

As in other countries, the data on wealth in Ireland are sparse. Furthermore, what data there are do not provide any insight into how concentrated or otherwise this wealth is. Clearly, the more concentrated that wealth is, the less difference it makes to retirement provision among the working population. A further question is whether wealth is correlated with pension provision, i.e. do those with significant non-pension assets tend to have pension provision as well?

- 4.15 By far the greatest part of non-pension wealth for most people is represented by personal home ownership. The Board continues to hold the view expressed in the NPPI Report that equity release schemes can play a useful and in some cases significant part in funding retirement, though people should not be pressurised into converting home ownership into pension income. However, given the relatively low take-up of such arrangements to date and what the Board believes to be a reluctance by many people to make use of the value of their homes, it does not believe it would be prudent to include these assets as being available for retirement provision. However, home ownership could play a more significant part in paying for long-term care – this is discussed further in section 10.6.
- 4.16 It is the Board's view that non-pension assets other than home ownership are concentrated among those groups who have the highest supplementary pension coverage. The Board is most concerned about coverage among those aged under 50 on medium and lower incomes in the private sector, especially women. The Board does not believe that property or other asset ownership is significant among this group. However, the Board recognises that further research in this area would be very useful.

- 4.17 In summary, the following are the Board's views on the development of supplementary pension coverage since the NPPI Report:

- The current level of coverage continues to be a cause for concern. The present level of coverage, if maintained will result in a major fall in income at retirement for much of the population, and for a significant minority, an unacceptably large fall, which may leave them at risk of poverty if they are solely dependent on a first pillar pension
- The Board does not believe it is possible to draw any conclusions at this stage from the CSO coverage statistics alone. Although the information is valuable, it is the Board's view that the changes seen since the 2002 QNHS are too small and over too short a period to allow any conclusions about the long-term trend to be discerned from them. Such views will have to be based on qualitative analysis.
- A number of members of the Board are of the view that it is too soon after the implementation of the major NPPI Report recommendations in 2003 for a comprehensive review of progress towards NPPI targets. The primary NPPI Report recommendations on coverage were not implemented until 2003, and the timetable for NPPI targets for 5 and 10 years and ultimate targets should be regarded as commencing at that stage, i.e. the target years are 2008, 2013 and some later year. The rate of coverage indicated in the 2004 CSO QNHS appears to be compatible with the achievement of the ultimate target in the post-2013 period. It is accordingly far too early in the process of reaching those targets for any change in the existing system to be predicated on the perceived non-achievement of targets
- A number of members of the Board believe that coverage targets need to be viewed as goals to be attained in a broad, flexible manner, on the basis that account must be taken of structural changes in the labour force over time. For instance, in regard to progress to date, cognisance must be taken of:
 - the fact that, as stated above, many persons in the 30-65 age group have joined the workforce in recent years and are correspondingly less likely to have invested in pensions in the meantime
 - the higher incidence now than before of small and medium-sized firms in the economy, especially in the services sector, with less history of pension provision.

In the same way, targets must be nuanced to take account of the presence in the economy of people who have adequate resources not to require formal pension provision, i.e. many in the top decile

- The Board recognises that there are significant assets outside the pensions system which will be available to their owners to provide retirement support. However, the high priority groups as identified in Chapter 3 are unlikely to hold significant amounts of such assets once the value of their family residence is excluded.

Adequacy

- 4.18 To date, focus on progress towards NPPI targets has understandably been on the coverage target. It is a prerequisite that people have supplementary provision of some description before considering whether or not it will be enough. Nonetheless, the coverage target must be seen as only the first step towards achievement of the 50% post-retirement income target, and the Board would be concerned were this income target lost sight of.
- 4.19 There is no single figure benchmark measure of adequacy levels comparable to the 2002 CSO QNHS coverage survey, and indeed, no agreed methodology for measuring progress nor any reliable means of gathering survey information. However, there are a number of sources of data which, taken together, allow a reasonable picture of typical supplementary provision to be compiled as follows:
- The Board's register provides data on the numbers of public service and private sector defined benefit and defined contribution schemes and the numbers of active members of those schemes
 - The Board in fulfilling its regulatory functions can build up a reasonably clear picture of typical private sector defined benefit pension benefits
 - The Irish Association of Pension Funds produces a regular benefits survey which provides information on contributions to defined contribution schemes. A recent paper prepared by a Society of Actuaries in Ireland working party included a detailed analysis of a number of such schemes which provides further insight into the likely amount of defined contribution pension benefits
 - The amount of average Retirement Annuity Contract ("RAC") and PRSA contributions can be calculated from insurance companies and Board data. The CSO is currently matching data from the PRSA register with earnings as recorded in the P35 and self-employed income tax collection systems. Overall contribution rates are likely to be about 9% of earnings and vary by gender and age.
- 4.20 From the above, a reasonably complete picture can be built up of current pension provision and the likely amount of pension benefits. The main features are as follows:
- Adequacy is primarily a private sector issue: most public service pension schemes will provide benefits after long service which, when added to any first pillar entitlement, will provide a retirement income at least equal to 50% of pre-retirement income
 - The majority of private sector defined benefit schemes will provide benefits greater than the NPPI target at retirement for those who have spent most of their working life in the scheme. However, most people in the private sector do not remain with the same employer throughout their working lives, and as a result, retirement income is likely to be reduced because of changes in employment and scheme membership. This is particularly true for women
 - Because of typical contribution levels (commonly about 10% of earnings in total), the great majority of defined contribution scheme members are unlikely to have a retirement income equal to or greater than the NPPI target, irrespective of the length of time they are members of the scheme

- Contribution data indicate that additional voluntary contributions ("AVCs") are increasingly likely as scheme members approach retirement. However, the typical contribution rate is nonetheless unlikely to provide NPPI target benefits
- It is difficult to draw conclusions about adequacy from PRSA and RAC data because of the lack of income data in the latter case, and because savers may have multiple contracts. Nonetheless, the typical contribution levels along with anecdotal evidence from those in the pension industry seems to indicate that typical individual contributions are proportionately less than for OPSs
- Even where an OPS provides benefits close to the NPPI target level, inflation can erode the value of the benefits in payment surprisingly quickly. For instance, over the ten years to 2004, a period that would be considered to be one of comparatively low inflation by recent Irish standards, a pension of a fixed amount would have lost one quarter of its real value. Almost all public service pension arrangements provide increases after retirement equal to or above the rate of price inflation. On the other hand, although no definitive figures are available, it is generally accepted that only about one third of OPSs provide guaranteed increases, and a further third provide ex gratia increases, and few of those would provide increases equal to the rate of inflation. This is of particular concern as life expectancy improves.

4.21 Since the NPPI Report was published, there does not appear to be any improvement in the adequacy of pension provision. Defined benefit schemes represent a reducing proportion of employer sponsored second pillar pensions, and such schemes usually provide higher benefits than defined contribution arrangements, so adequacy may well be deteriorating. There is no evidence of significant increase in the level of typical defined contributions; indeed it is questionable whether the contribution rates are even keeping pace with the increase in pension costs due to improvements in life expectancy.

Women and pensions

- 4.22 The levels of coverage and adequacy for women are of particular concern to the Board. In his letter to the Board in February 2005, the Minister of Social and Family Affairs asked that the NPR specifically address this issue.
- 4.23 Coverage and adequacy is lowest among the lower paid, among younger members of the workforce and among part-timers. Because women comprise a greater proportion of each of these groups, and because of their typical work patterns throughout their lives generally, they are more likely than men to have inadequate pension provision, if any. Furthermore, women are more likely to have taken time out of the paid workforce to care for children, which affects both the likelihood of pension saving and its adequacy. However, in addition to this, there are other factors at work which affect women's pension provision. The proportion of pension contracts begun by women is less than would be expected, even allowing for lower average income and age. Furthermore, PRSA and other data show that the average pension contributions made by women are less than by men, even after adjusting for differences in age and income.
- 4.24 Any pension initiatives or changes aimed at the lower paid and younger workers will benefit women, and help close the provision gap. However, there are other economic, social and cultural factors operating, which appear to make pensions a lower priority for many women, and make them less likely to provide for themselves. Further research is needed to enable us to understand why women's provision is so low. Also, further specific initiatives will be needed to raise awareness among women of the need for retirement provision.
- 4.25 Prior to 1994, many women's entitlement to the OACP was reduced as a result of time out of the workforce, usually while working in the home. In 1994 the Homemakers Scheme was introduced and it works by disregarding up to 20 years spent out of the workforce caring for children etc when a person's insurance record is being averaged for pension purposes, though the scheme will not of itself qualify a person for a payment as the basic qualifying conditions for pensions have also to be met. In this regard, qualifying conditions for minimum pensions have been considerably eased since 1997 and pro-rata pensions introduced for people with PRSI contributions at different rates. These changes are of particular benefit to women with reduced insurance records.

Future prospects

4.26 2005 is a time of considerable change in pensions. Among the most important trends are:

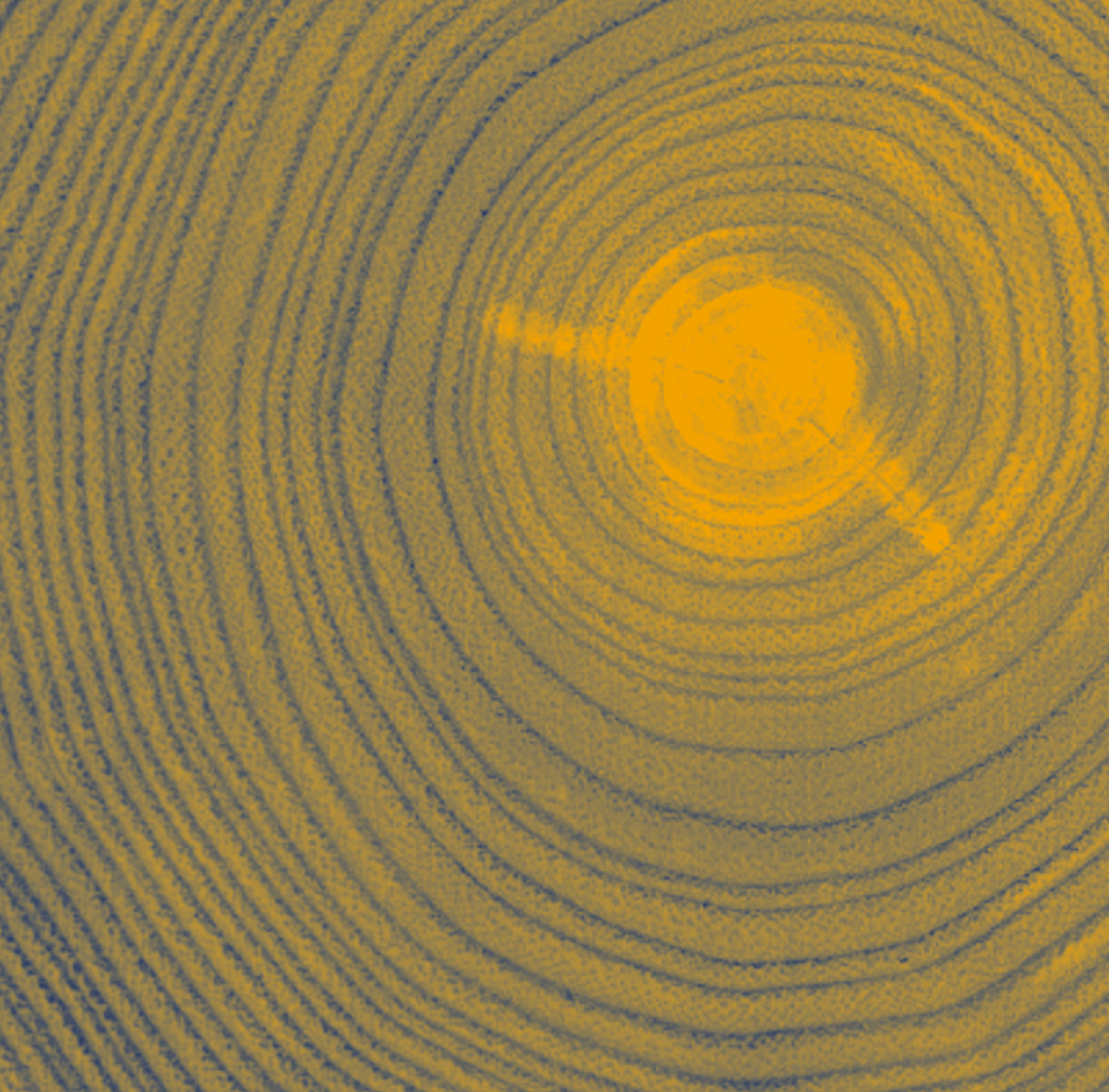
- Board surveys have shown that pensions awareness has increased considerably in recent years. However, there is no evidence that this is translating into a rapid increase in coverage
- Pensions are much more expensive than they used to be, because of lower investment returns, the effect of lower interest rates and increased life expectancy. There does not appear to be good public awareness of the cost of a reasonable retirement income
- Membership of defined benefit schemes continues to increase slowly although it forms a declining percentage of total coverage. However, this increase is almost entirely due to increases in membership of existing schemes: the only new defined benefit schemes appear to be as a result of restructuring of existing schemes or occasional single member arrangements. Despite the increase in membership, the Board has concerns about the future for defined benefit provision in the private sector
- Pension providers have frequently expressed the view that it is uneconomic to market pensions to the lower paid, because of the costs of complying with regulation. These costs are a fixed amount per person, and the effect is therefore to make small pension contracts unprofitable. Such a view is a considerable obstacle to increasing pension coverage among younger workers and the lower paid, who are the Board's priority for achieving the NPPI targets.

4.27 The Board received a large number of submissions to the NPR, including almost all major organisations concerned with pensions. All proposed some change to the second pillar system, in some cases quite radical. The view of the great majority seems to be that the current system needs reform in order to increase coverage and achieve adequacy.

4.28 It is the view of most of the Board that the NPPI coverage and adequacy targets will not be met without some change to the present pension systems. It is their opinion that current pension awareness activities and existing incentives are not achieving and will not achieve the level of retirement provision set out in the NPPI Report.

A number of those on the Board believe that insufficient time has elapsed since the implementation of the NPPI recommendations to draw clear conclusions about the outlook for second pillar provision and the prospects for achieving the NPPI coverage and adequacy targets. Some of these members believe that the targets should be seen as aspirations rather than targets.

In light of the above, the Board considered a number of possible changes ranging from enhancements to the current system to making radical changes to the structure of the system itself. These are examined in Chapters 7 and 8.



CHAPTER 5

SUSTAINING THE FIRST PILLAR

CHAPTER 5 – SUSTAINING THE FIRST PILLAR

Introduction

- 5.1 The report by LS/ESRI included projections of the cost of the current pension system. As is shown below, these project a significant increase in the annual costs of first pillar pensions and public service pension costs.

It is the Board's view that the projected increase in these costs is a significant challenge to pension provision. Although the primary purpose of the NPR is to consider how to improve pension provision, maintaining the current level of provision, particularly first pillar provision, is the obvious first step.

Projected costs of first pillar

- 5.2 The LS/ESRI report projects the cost of current first pillar benefits on a number of bases. The tables and figures used in this section are taken from the central basis of projection used by LS/ESRI. Readers are referred to that report for a full explanation of the topic.

Table 5.1 shows the projected costs of paying first pillar pensions, expressed as a percentage of Gross National Product ("GNP"). Note that these costs assume an OACP equal to the NPPI target of 34% of GAIE, whereas the current OACP is 32% of GAIE.

Table 5.1 – projected cost of first pillar pensions as a % of GNP

	2006	2016	2026	2036	2046	2056
Current	3.0%	3.7%	4.9%	6.5%	8.7%	10.1%

The underlying cause of the increased cost is that the projected numbers aged over 65 are expected to triple in the period under consideration. In the same period, the numbers at work are only expected to show a much smaller increase. Table 5.2 compares the projected numbers aged over 65 with the numbers projected to be at work, and shows the ratio.

Table 5.2 – projected ratio of those at work to those over 65

	2006	2016	2026	2036	2046	2056
Nos. at work (000)	2,001	2,213	2,268	2,268	2,170	2,125
Aged over 65 (000)	464	620	844	1,105	1,403	1,532
No. at work per person over 65	4.3	3.6	2.7	2.1	1.5	1.4

- 5.3 Following the publication of the NPPI Report, the NPRF was established under the National Pensions Reserve Fund Act, 2000. The purpose of this is to attempt to smooth, by means of pre-funding, the projected increase in the costs of first pillar and public service pensions. It is important to note that the NPRF as set up, based on an annual Exchequer contribution equivalent to 1% of GNP, was never intended or expected to meet all of the increase in those costs. The original estimate at the time of its establishment was that the NPRF would cover approximately one-third of the demographically induced increase in the cost of first pillar and public service pension provision up to 2055, and that roughly one third of the NPRF would be used for public service pensions and two thirds for first pillar pensions.

Table 5.3 shows the LS/ESRI projected net costs of first pillar pensions and public service pension provision, after allowing for the income from PRSI contributions and the net contributions to and from the NPRF.

Table 5.3 – projected net costs of State pensions as % of GNP

	2006	2016	2026	2036	2046	2056
Pillar 1	3.0%	3.7%	4.9%	6.5%	8.7%	10.1%
Public service	1.3%	2.1%	2.8%	3.3%	3.6%	3.7%
Total	4.3%	5.8%	7.7%	9.8%	12.3%	13.8%
PRSI conts.	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
NPRF	1.0%	1.0%	0.7%	(0.9%)	(2.7%)	(3.5%)
Net	1.6%	3.1%	4.7%	5.2%	5.9%	6.6%

Two points should be borne in mind in considering these projections:

- On the Board's advice, the PRSI contribution projections assume that 85% of total PRSI contributions will be available to fund retirement benefits throughout. This percentage is difficult to predict, and in particular, is vulnerable to any significant increase in unemployment and other Social Welfare claims. The percentage assumed is likely to be viewed as towards the optimistic end of reasonable assumptions. The current share of PRSI contributions accounted for by first pillar pensions is about 60%, but this is expected to rise significantly as the population ages
- Legislation does not define the detail of the timing or amount of withdrawals from the NPRF to meet future pension costs. The LS/ESRI assumptions were decided after discussions with the National Treasury Management Agency, who manage the NPRF.

The effect of taking PRSI contributions and NPRF payments into account is to reduce the maximum yearly cost, and to reduce the rate of increase in the long-term. However, the net cost is expected to increase rapidly until 2025, and to remain at a high level thereafter. At present, the assumed percentage of PRSI contributions more than covers first pillar retirement pension costs, but within 10 years, this is not likely to be true.

- 5.4 The projected first pillar costs are considerably higher than those prepared for the most recent actuarial review of the Social Insurance Fund as at end December 2000, completed in mid 2002. This change reflects the rapid demographic changes which Irish society has undergone and is continuing to experience: a combination of rapidly increasing life expectancy and dramatic changes to the patterns of migration and the labour force.

These projections of pension costs are not predictions and must not be used as such. Rather they are best estimates of the future situation based on a set of reasonable assumptions. It is important that future pension costs continue to be projected at regular intervals as a basis for policy debate and formulation.

However, the inevitable changes over time in cost projections and in particular the significant difference between these results and previous projections must not be used as a reason to ignore the important information they provide. It is inevitable that the numbers of people aged over 65 in Ireland will increase considerably in coming years, and that the increase will be considerably higher than the proportionate increase in those at work. Furthermore, this increase is not a distant future event: the projected results for 2016, which are the most reliable of the projections (as demographic projections are more reliable over a shorter period of time), already show a noticeable increase in pension costs. However, it has been argued that if productivity increases are higher than earnings increases, then the first pillar and public service pension costs become more sustainable.

Sustaining the first pillar system

5.5 There are four options available to deal with the increasing cost of first pillar pensions. These are:

- (i) to reduce the value of Social Welfare benefits, including pensions;
- (ii) to meet the increased costs from increased taxation and/or PRSI contributions;
- (iii) to defer the age at which retirement benefits are paid; or
- (iv) to increase the advance provision, currently done through the NPRF.

In practice, the policy is likely to be a combination of a number of the options listed above.

5.6 In relation to (i), the Board confirmed its acceptance of the NPPI targets in Chapter 3 including the minimum income target. The Board does not therefore support any reduction in the level of first pillar pensions, even as a means of improving the sustainability of the benefits.

In relation to (ii), while such an approach would be consistent with the Pay-As-You-Go ("PAYG") system, the scale of the increased taxation/PRSI contributions needed to meet the increased cost in full means that other approaches need to be considered in conjunction with or as alternatives to such increases. Accordingly, the rest of this chapter considers the possible approaches outlined in (iii) and (iv) i.e. later retirement benefits and increased pre-funding.

Later retirement benefits

Overview

5.7 A number of countries have changed or considered increasing the age at which first pillar pensions become payable, as a response to increasing costs and unsustainability. It should be noted that this is usually where the retirement age is lower than 65. In general there is considerable reluctance to do so, and much public opposition.

The increasing cost of Irish first pillar pensions, in common with that of most other countries, is driven not just by the increasing proportion of pensioners in the population, but also by increasing life expectancy. The increasing life expectancy means that the time in retirement is increasing. Although everyone might like to have the option of retiring as early as possible, it is reasonable to consider whether this represents the most efficient use of finite resources. In particular, it should be considered whether it is better to pay a relatively lower pension from age 65 or a higher pension from a later age.

Sections 5.8 to 5.10 examine the recent increases in life expectancy, the future outlook and the effect of this. Sections 5.11 to 5.14 look at a number of possible approaches to increasing retirement age.

Increasing life expectancies and their effect

5.8 Table 5.4 shows the most recent life expectancy at 65 for men and women as calculated by the CSO in 2002, and shows the corresponding figures for previous years:

Table 5.4 – Irish life expectancy at 65 (CSO data)

Year	Men	Women
2002	15.4	18.7
1991	13.4	17.1
1979	12.4	15.4
1951	12.1	13.3
1926	12.8	13.4

It is important to note that the figures shown for each year are based on the death rates at that time, i.e. what is shown is the life expectancy if mortality rates remained unchanged from then on. However, as mortality rates are expected to continue to improve, the estimated life expectancy of someone currently aged 65 is almost certainly greater than that shown above.

It is also worth noting that life expectancy differs noticeably by socio-economic class. These differences have not narrowed as a result of recent improvements.

- 5.9 Despite the considerable increases in recent years, Irish life expectancy is still below the Organisation for Economic Co-operation and Development ("OECD") countries' averages, as shown in table 5.5.

Table 5.5 – OECD comparison of life expectancy (2000)

Expectancy at 65	Men	Women
Japan	17.5	22.4
France	17.2	21.6
Italy	16.5	20.6
USA	16.0	19.2
UK	15.1	18.6
Ireland	14.3	18.1

Note that the life expectancies in this table date from 2000, and so differ from those shown in table 5.4.

In their report, LS/ESRI estimated Irish life expectancies in the future. These are shown in table 5.6:

Table 5.6 – projected life expectancy at 65 (LS/ESRI, central scenario)

	2006	2016	2026	2036	2046	2056
Men	16.0	17.6	19.2	20.6	21.3	22.0
Women	19.4	20.9	22.4	23.9	24.6	25.3

As for table 5.4, the figures in table 5.6 have been calculated allowing for projected improvements in mortality until the year in question, but with no allowance for expected future mortality improvements beyond that date. However, it is important to note that the calculations undertaken by LS/ESRI allowed fully for all projected mortality improvements.

- 5.10 The CSO data show that life expectancy at 65 increased by three years between 1979 and 2002. The LS/ESRI projections assume that life expectancies will continue to improve by more than one year each decade.

The increase in life expectancy is a result of Ireland's increased wealth and better health, and is very welcome. However, there seems to be little public awareness either of the current life expectancies at retirement or how fast they are increasing.

As a result of the increasing life expectancies, the total value throughout retirement of first pillar pension benefits is increasing, over and above the payment rate increases granted in the annual Budget. At present, rates of increase in length of retirement, the value of the OACP is increasing by roughly 1.5% per annum in real terms over and above the increases added in the annual Budget. However, so far

the perceived cost of increased life expectancy has been relatively minor. Because the cost of first pillar retirement benefits is not capitalised other than in the periodic actuarial valuations, the cost only becomes apparent as people survive longer rather than when they first retire.

- 5.11 If the age at which the first pillar pensions were paid was raised, there would be an eventual reduction in the cost of those benefits. This reduction would be approximately 5% of the total cost for each year retirement was raised. Table 5.7 illustrates the approximate long-term effect of raising the retirement age to 70. It is important to emphasise that this is an illustration only, not a policy proposal.

Table 5.7 – Approximate cost effect of increasing retirement age to 70 as % of GNP (estimated from LS/ESRI projections)

	2016	2026	2036	2046	2056
Age 70	2.4%	3.4%	4.7%	6.4%	8.1%
Age 65	3.7%	4.9%	6.5%	8.7%	10.1%
Difference	(1.3%)	(1.5%)	(1.8%)	(2.3%)	(2.0%)

The results assume that the current pattern of retirement benefits would continue from the new retirement age, and ignores the complexities arising from the State Retirement Pension ("SRP").

Depending on its effect on employment patterns, raising the State pension age would increase the size of the workforce, and would be likely to have some positive effect on GNP – no estimate of this is included in any of the figures, as it is not likely to be proportionately significant.

Some proportion of those no longer eligible for first pillar retirement benefits would qualify for unemployment or other Social Welfare benefits, and this would reduce the above savings. On the other hand, no allowance is made for possible increased PRSI income from those working beyond 65. More detailed modelling would be required to produce a more accurate estimate of the cost effects.

- 5.12 In other countries it is common for any changes to the retirement age to be introduced gradually, so that a higher retirement age applies only to those with more recent years of birth.

One suggestion is that a higher retirement age would apply only to those joining the workforce now, which we could take as those born in 1985 or later. This may be an appropriate approach, but it should be noted that it would have no financial effect until after 2050.

An approach adopted by a number of countries is a gradual increase in retirement ages, but which nonetheless will apply to some extent to younger workers. An example of such an approach is given in table 5.8. Although the table is arbitrary, it should be noted that the projections underlying the LS/ESRI report show a life expectancy that increases very roughly by one year every ten years, so the table is consistent with this.

Table 5.8 – example of gradually increasing retirement age

Year of birth	Age in 2005	Retirement age
Up to 1960	45 and older	65
1961 to 1970	35 to 44	66
1971 to 1980	25 to 34	67
1981 to 1990	15 to 24	68
1991 to 2000	5 to 14	69
2001 or older	4 and younger	70

The effect of this approach on the projected costs of first pillar pensions is shown in table 5.9.

Table 5.9 – effect of gradually higher retirement age on projected cost of first pillar (% of GNP)

	2016	2026	2036	2046	2056
Increasing	3.7%	4.6%	5.8%	7.3%	8.5%
Age 65	3.7%	4.9%	6.5%	8.7%	10.1%
Difference	(0%)	(0.3%)	(0.7%)	(1.4%)	(1.6%)

While the savings would take some time to build up, they are potentially quite significant in the longer term in terms of percentage of GNP and particularly in absolute amounts of Exchequer saving.

Approach in other countries

5.13 The question of increasing retirement age for first pillar benefits has been considered in many countries. Among the most notable are:

- In the U.S. in the 1980s, the Social Security retirement age was increased. The change did not take effect until 2003. Retirement age now depends on year of birth as follows:

1937 or earlier	65
1938	65 and 2 months
1939	65 and 4 months
1940	65 and 6 months
1941	65 and 8 months
1942	65 and 10 months
1943-1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and later	67

- In the U.K., first pillar pensions for men are payable from 65, but for women have until recently been payable from age 60. The female retirement age is now being increased to 65 on a phased basis up to 2020. The Work and Pensions Secretary has recently said that a debate was needed in the U.K. about raising the pension age further
- In Germany in 2003, the Bundestag enacted short-term measures to stabilize the level of retirement pension contributions in 2004. These included: deferring the increase in pensions from July 1, 2004 to July 1, 2005; deferring pension payments for new retirees to the end of the month and gradually increasing the retirement age from 60 to 64 from 2006 onwards for participants in part-time working arrangements. Increases in all retirement ages were considered and Germany's new coalition Government is considering a proposal to increase the retirement age from 65 to 67
- Increases in the State retirement age have been considered or proposed in a number of countries, and in many cases rejected, for instance in Switzerland in 2004.

Advantages and disadvantages

- 5.14 The primary argument in favour of increasing the State retirement age is financial – the estimate given above for the cost of first pillar pensions out to 2056 at the 34% of GAIE benchmark is a reminder of the cost associated with demographic changes and increased life expectancy. However, a further argument in favour of such an increase is on grounds of inter-generational equity. As a result of greatly improving life expectancy in the decades ahead, the duration of post retirement lifespans would increase indefinitely if the State retirement age were not increased; payment of pensions for those periods of increased duration is not sustainable in the long-term without a proportionate increase in the period of time spent in the labour force.

A number of other issues raised by an increased State retirement age would be:

- Competition for employment would be increased for those not yet eligible for the first pillar pension. This could have some effect on unemployment and earnings
- There would be a knock-on effect on the benefits provided by OPSs, in practice if not in law. This would be especially true for integrated defined benefit schemes.

There is considerable opposition to any increase in the State retirement age. Among the arguments against it are:

- First pillar pensions are seen as a contract between contributors and the State. For the State to unilaterally change the terms of the contract would be seen to be a breach of faith
- Because life expectancy is lower for those on lower incomes, any increase in the retirement age would have a proportionately greater effect on the less well off
- In addition, higher earners are more likely to have other resources to allow them retirement flexibility, whereas lower earners would be wholly dependent on the first pillar pension.

Flexible retirement for first pillar

- 5.15 It has been suggested that those entitled to an OACP should be allowed to defer the start of their benefits in exchange for a higher benefit beginning later. The higher later benefit would be calculated so that the total expected value of the deferred benefit would be no lower than the value of the entitlement from age 65. The entitlements of those who chose to retire at 65 as at present would be unaffected. It is not proposed that there be any entitlement to draw first pillar pensions from any earlier age in exchange for a reduced benefit. Note that the suggestion that employers would not have the right to oblige retirement at 65 is a separate issue, discussed separately: what is being considered here would affect only first pillar pensions.

Among the advantages of this proposal are:

- Those who have the opportunity to continue in employment and wish to do so can accrue extra retirement benefits, both through additional first pillar entitlements and through having extra time to make second pillar provision.
- There is a widely held view that the current OACP is too low. However, maintaining it at the current level, let alone increasing it, poses a significant financial challenge. This proposed flexibility would at least provide higher benefits for those in a position to defer drawing their benefits.

A very approximate calculation indicates that deferring a pension from 65 to 70 could allow a pension from the later age that would be one third higher than the entitlement at 65, or a little over 6% for each year that pension is deferred. This assumes that if the claimant dies between 65 and 70 before claiming the pension, a lump sum equal to the pension foregone would be paid to the claimant's estate.

No account is taken in the above estimate of any additional PRSI contributions between 65 and 70. However, if such a model could be combined with allowing those with less than full entitlements to count contributions made after age 65 or 66 in order to improve their contributions record, this would complete the incentives for longer working within the first pillar system. This would, of course, require employment after age 66 to be made fully insurable.

It is difficult to see any objections in principle to this proposal. However, there are a number of practical issues which must not be underestimated. In particular, the SRP is payable between 65 and 66 only to those who have retired. If deferring retirement allowed credit for the SRP not claimed, the result would be a significant additional cost to the Exchequer, because not everyone would have claimed it. On the other hand, if no credit is allowed for SRP not claimed, there would not be any worthwhile incentive to defer retirement.

The representative of the Minister for Social and Family Affairs has indicated that in principle the Department supports the introduction of flexibility in the OACP, but would not support any scheme which allowed these benefits to be claimed before age 65. The Board recognises that this proposal would have practical implications for the operation of integrated defined benefit schemes.

- 5.16 The Board recommends that retirees should be offered the option of deferring drawing their first pillar pension in exchange for a larger pension starting at a later date.

Retirement age in second pillar pension arrangements

- 5.17 One suggestion made to the NPR has been that members of OPSs would have the option (but not the obligation) to remain in employment beyond the retirement age of their OPS, and be allowed to continue as members of the OPS. The purpose of this proposal is that such employees could use the additional period of employment to accrue further pension if their entitlements at normal retirement would not be adequate. A further development of this proposal is to allow employees the option of part-time working combined with partial drawdown of any pension entitlements.

It is worth noting that recent changes to the terms of public service pensions mean that those who have begun employment since 2004 have no maximum retirement age and can work as long as they choose to and are able to.

- 5.18 While provisions for early retirement can exist, the majority of OPSs have a normal retirement age of 65, with a relatively small proportion having a retirement age of 60 to 64, and a very small number allowing earlier retirement for specified professions. Some of these schemes do have provision for late retirement, almost always relying on the consent of the employer. The increase in life expectancy has affected the provision of supplementary pensions as follows:
- For members of defined contribution schemes or contributors to PRSAs and RACs, the effect of the increase in life expectancy is to reduce their retirement benefits because the amount they save will purchase less pension. The recent fall in interest rates and the low returns on equities has meant that it has not been easy to distinguish the effect of improved life expectancy separately from other factors. However, the changes in life expectancy over the last 10 years would have on their own caused a fall of approximately 10% in retirement incomes
 - The effect on defined benefit schemes has been more complex. Again, it has been obscured by investment losses and interest rate falls of recent years. However, the underlying result has been an increase in benefit costs. This has been more than 10% because not alone have actuarial valuations reflected the increases seen to date, but they also reflect the belief that mortality is likely to continue to improve at a faster rate than was previously expected

In many defined benefit schemes, the cost of the improvement in mortality has been met wholly by the employer. However, because of this increasing cost, a number of these schemes have been closed to new entrants who may have a defined contribution scheme instead. At least part of the effect of the mortality changes has therefore been borne by employees with shorter service, whose benefits at retirement in the replacement scheme will be less valuable. In other defined benefit schemes, members may also (in some schemes with the members' agreement) have had their contribution rates increased, and in some cases, benefits may also have been reduced

- The impact of mortality improvements will be increased because people are joining the workforce later. Thus, the cost of a longer retirement has to be financed during a shorter working life.

- 5.19 It is important to emphasise that many in employment look forward to retirement, and this proposal would not change their situation. It would only affect those who wished to continue in employment.

The suggested change to allow optional later retirement could be implemented by prohibiting the imposition by employers of any mandatory retirement age, or by prohibiting any mandatory retirement age less than, say, 68 or 70 except for a small number of occupations. This would allow employees more flexibility in meeting their retirement savings needs, and would also have the beneficial effect of allowing those who wish to continue working to do so.

- 5.20 There is, however, some opposition to this proposal. It has been said that some employees, especially in manual occupations, would not be physically able to work beyond 65 and in some cases even before that. The existing retirement practice allows employers to deal with this situation without having to invoke assessment processes, which would be very difficult for all involved. Were the mandatory retirement age raised or removed, there might be employees who wished to continue working but were not capable of doing so.

Reference has been made earlier to the issue of inter-generational equity in regard to the State retirement age i.e. increases in the duration of post-retirement lifespan due to improved life expectancies being matched by proportionate increases in the duration of labour force participation. This consideration applies with equal validity to occupational pensions. Already, changes have occurred in the public service and the matter of increasing retirement ages in the private sector through the normal industrial relations process needs to be dealt with.

It is the view of the representative of the Minister for Finance that, in the years ahead as the median age in the work force and general population increases, the relative scarcity of younger workers will lead employers to retain older workers and to invest in the upgrading of the skills of those workers. Given the increased incidence of older people in the consumer market, it will be in employers' interest to have older workers in their workforce for ease of communication with an ageing market. It should be left to the industrial relations process to develop a workforce where employees' rights to work for as long as they wish in terms of pension rights are balanced by employers' rights in regard to a productive workforce geared to market needs. It should be noted that even now there is evidence of negotiations being successfully concluded with existing workforces in Ireland over retirement ages, with, for instance, normal retirement ages being maintained for employees over 50 and higher retirement ages being agreed to for younger age groups. It should also be emphasised that, with defined benefit schemes set to decline as a proportion of the private sector pension provision, partly due to employer reluctance to bear all the risks inherent in defined benefit schemes, but also because defined contribution schemes are more suited to mobility within the labour force, the basic uncertainties surrounding the value of the "pension pot" available at retirement will compel many employees to remain longer in the labour force than they would have contemplated under a defined benefit regime, with its comparative certainties about post-retirement income.

Pre-funding the first pillar

- 5.21 Following the NPPI Report, the NPRF was established by the Government with the objective of pre-funding part of the demographically induced increase in the cost of first pillar and public service pension provision. It was estimated at the time of its establishment that the fund would cover approximately one-third of the cost increase. The report of the Commission on Public Service Pensions (2000) had also made suggestions about the possibility of pre-funding certain benefits. However, as the LS/ESRI projections have shown, the cost of both first pillar and public service retirement benefits is likely to be significantly greater than originally estimated. It should therefore be considered whether the current Exchequer contribution to the NPRF should be increased.

In this context the National Pensions Reserve Fund Act, 2000 provides that, from time to time, assessments should be made of the profiles of Exchequer outlays on first pillar and public service pensions and the National Pensions Reserve Fund Commission plans to commence this work towards the end of 2005.

What follows sets out the issues that must be considered in a discussion of pre-funding of State benefits:

Ensuring entitlement

- The entitlement of current PRSI contributors to a retirement pension and especially to a pension that retains its real value depends on the actions of future Governments to maintain that value in the annual Budget: contributors have no enforceable entitlement to any specific benefit. The existence of a substantial NPRF will both make it easier for future Governments to meet contributors' expectations, and make it less acceptable to reduce entitlements.

Taxation versus accumulation of assets

- Future pensions can only be paid from the wealth generated by the working population at the time the pension is paid. These resources can be diverted from those that create them by taxation (i.e. through a PAYG system) or by asset sales on behalf of retirees to the working population (i.e. accumulating these assets through pre-funding and then selling them) or by a combination of these approaches. However, the LS/ESRI projections show that the numbers of pensioners per worker will almost triple, and there is considerable concern that the scale of tax increase needed may not be sustainable. Hence the argument that the pension commitments should be at least partly pre-funded.

Because pensions can only be paid by taxation or by selling assets to the future working population, it has been pointed out that the difference between funding and PAYG is only a different means of organising the future transfer of assets. In particular, if there is a considerable increase in pensioners, and they are trying to fund their retirement by selling accumulated assets (be those assets held privately or through the NPRF) then the price they can realise for those assets will fall if non-pensioners are not willing or able to buy those assets. The difference between funding and PAYG is the difference between the uncertainty of future asset values and the uncertainty of future taxation. Some would argue that policy should therefore incorporate both future taxation and pre-funding, to balance the uncertainties of each.

Overseas investments

- It should be pointed out that the problems of selling assets in the future are unlikely to be avoided by investing overseas. Ireland is demographically 'younger' than most other countries, and so the challenges of providing pensions to a greatly increased number of claimants will generally occur after it happens in many other countries

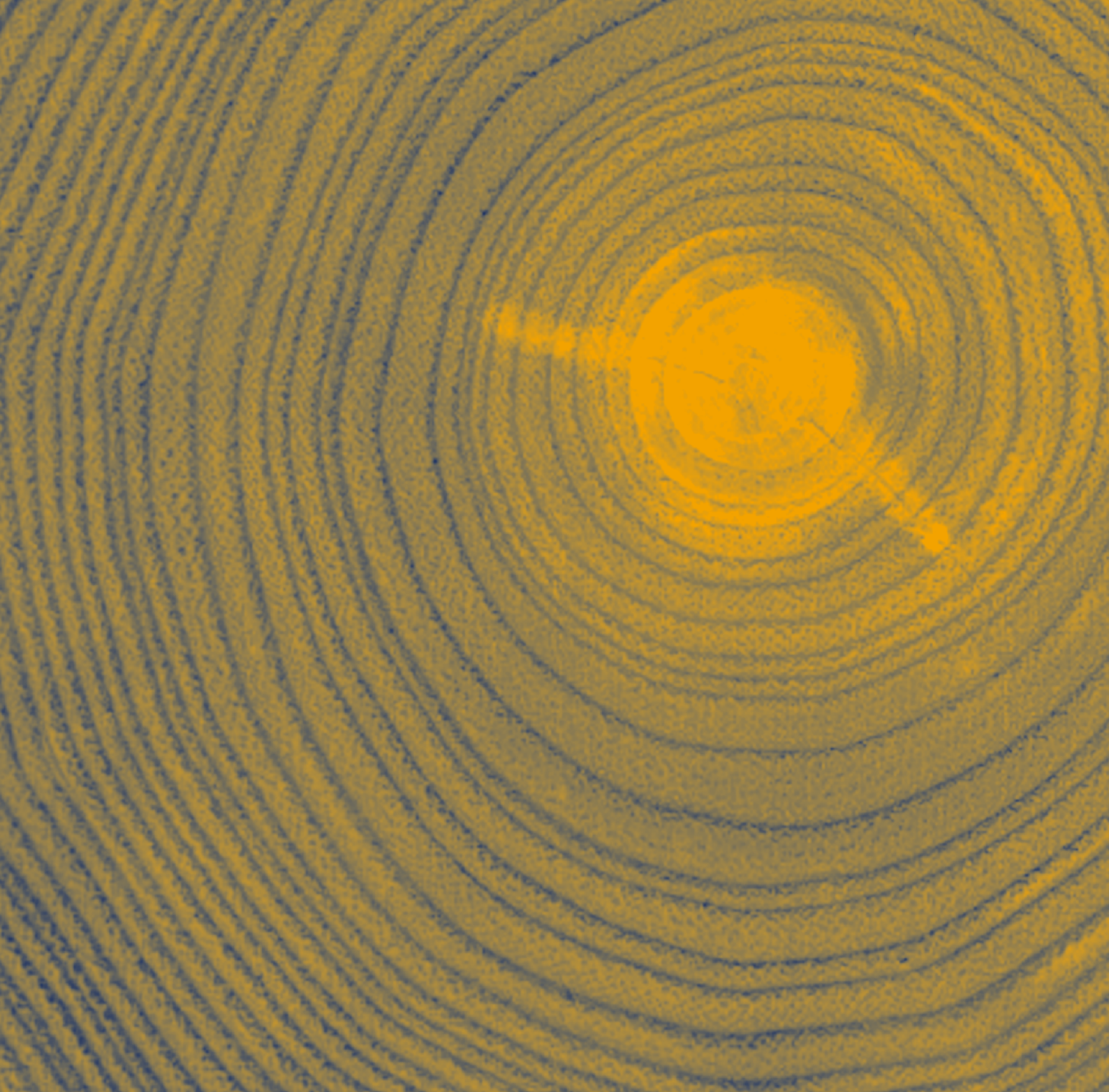
The argument for overseas investment is that it reduces investment risk, i.e. the future return on the fund is not dependent on the future of the Irish economy. Against this some argue that the considerable assets of the NPRF should be invested productively in Ireland rather than overseas, in order to increase the long-term wealth of the Irish people.

Other considerations

- Although there are uncertainties and difficulties about the economics of pre-funding, these arguments do not necessarily mean that pre-funding is a poor idea: they would be interpreted by some to mean that pre-funding is not a certain panacea but has nonetheless not been proven to be any worse than simply relying on future taxation. It can therefore be argued that, as Ireland is at present well-off by its own historical standards, it makes sense to increase pre-funding when the resources are more easily available than they might be in the future
- One argument that has been made against substantial pre-funding of State commitments is that it will be politically impractical to maintain such a fund, and in particular to maintain contributions to it in years of budgetary difficulty
- The current generation of PRSI contributors are paying the first pillar pensions of previous generations through their PRSI contributions, as that generation paid for the first pillar pensions of the previous generation, and so on. Any pre-funding of the pensions of the current generation can only be made from current tax revenues, i.e. from the resources of the current generation. This generation will therefore end up paying both for the first pillar pensions of the previous generation and, at least partly, for their own. This is sometimes seen as unfair. However, it may be seen as the only way for this generation to ensure that their expectations are met, in light of the considerable future increase in pensioners relative to the size of the workforce and the consequent proportionate increase in cost. The cost will otherwise be borne by the next generation, who may see the burden as unfair or even unacceptable
- Increased pre-funding would divert resources required for capital spending, in particular in the infrastructural area, on a scale which would be seriously detrimental to the needs of the economy. In addition, the proposal would have to be assessed in the light of competing demands on the public expenditure front from, for instance, the health, long-term care and education areas and in the context of declining EU receipts in future years. It must also be taken into account that the present generation of workers are funding the bridging of the infrastructural deficit in progress at present, from which succeeding generations will benefit. Accordingly, it might be regarded as unfair that they should have to also shoulder the burden of pre-funding future generations' pension liabilities
- Pre-funding would introduce a further rigidity into the framing of fiscal policy, when options in that field have been curtailed as a result of EU monetary union.

5.22 The cost of first pillar pensions will increase very significantly in the future, and steps will be needed to ensure these pensions can be maintained. Among the ideas that could be considered in addition to or as an alternative to PRSI or taxation increases are:

- Increasing on a phased basis the age at which first pillar pensions are paid; and
- Increasing the Exchequer payment into the NPRF.



CHAPTER 6

STRATEGIC OPTIONS FOR MEETING TARGETS

CHAPTER 6 – STRATEGIC OPTIONS FOR MEETING TARGETS

- 6.1 The targets set out in this Report must be understood as retirement income targets, not structural prescriptions. The aim of pension policy should be the achievement of the income targets and the NPR considers all alternatives for their achievement.
- 6.2 The NPPI targets comprise a basic income to prevent poverty, and a supplementary income to replace a proportion of pre-retirement income. This reflects the structure of the current Irish system.
- 6.3 There are a number of possible approaches to providing retirement income in excess of the current OACP. The spectrum of potential structures includes:
- Flat rate State provision – i.e. a significant increase in the level of the current first pillar pensions
 - Earnings related State provision – this could be linked directly to earnings or to earnings related contributions, and would be mandatory
 - Mandatory private provision
 - Incentivised voluntary private provision – this is the current system
 - Neutral voluntary private provision – i.e. no incentive for supplementary provision.

It is within this range of structures that any potential proposals will lie.

- 6.4 The PRSI based OACP is progressively redistributive: those on higher incomes contribute more than those on lower incomes, but receive the same benefit (subject to the appropriate number of contributions). In contrast, the supplementary system is not intended to be redistributive, progressively or regressively. However, there are a number of aspects of the operation of the tax incentives that are regressive:
- Because tax relief is granted at a contributor's marginal rate, higher rate taxpayers receive proportionately more relief
 - Higher earners are more likely to be members of supplementary pension arrangements than lower earners, and tend to contribute a greater proportion of their income. They therefore qualify for a greater share of tax reliefs, irrespective of the rate at which the relief is granted
 - The tax free lump sum payable at retirement benefits higher earners more than lower earners. The maximum tax-free lump sum permitted is based on earnings at retirement or accumulated fund, and is therefore usually bigger for higher earners, who are also more likely to save higher-rate tax.

The amount of tax relief on pension contributions granted each year does not reflect the true Exchequer cost of that relief, as these reliefs generate additional taxable income in future years. A true assessment of the cost would be the value of these reliefs less the present value of the future additional tax income. However, this net amount is not zero, i.e. the value of the future tax income is less than the value of the relief for a number of reasons:

- The average rate of tax paid in retirement on the additional income is usually lower than the rate at which income tax relief was granted
- The tax free lump sum at retirement exempts a significant part of the retirement fund from any tax at all, usually between 25% and about 35% (depending on the Revenue Commissioners rules relating to the amount that can be taken as a tax-free lump sum).

It should be noted that the rate of tax relief granted on employer contributions is usually less than that granted on employee contributions, and will often be less than the average rate of tax in retirement.

The argument has been made that allowing tax relief on pension contributions and taxing retirement income is not a subsidy, but merely allows earners to redistribute income from their working years, where they have high incomes, to their retirement, where their income is less, and as such is reasonable. However, because of the tax-free lump sum, the current system is not operating as a simple reallocation over time.

6.5 The Board's view is that, if incentives for the lower rate and non-taxpayers were to be improved, a contribution towards the cost could be achieved by imposing a cap on incomes for pension contribution and benefit purposes, but only if the derived savings are used to improve incentives for the lower rate and non-taxpayers.

6.6 Most assessments of the cost of support for supplementary systems include an estimate of the tax foregone on pension assets' investment income. However, it could be argued that this is not necessarily appropriate. There is a tax cost only if the investments would have been made in any case, whether or not there were incentives. In any case, when assessing alternatives to the current pension system, it would not seem to make sense to include a cost of tax foregone on investments that are not being made under the current system as an Exchequer cost.

6.7 State support for pensions comprises first pillar pensions currently being paid to pensioners and tax incentives for those in employment saving for retirement from current earnings. It is appropriate to consider whether the support is reasonably distributed between the two areas, but in doing so, it is important to calculate the cost of that support accurately.

In considering the level of support for current first pillar pensions, it must be remembered that current pensioners have made PRSI contributions during their working lives. The total amount of pensions paid in any year overstates the cost to the State, as it does not take account of the value of the contributions made in the past. Similarly, the amount of tax relief granted in each year for supplementary pensions does not make allowance for the future income tax payable on those pensions. Also, of course, the size, age profile and income level of the two groups are different and are constantly changing.

6.8 It is the Board's view that State support for current pensioners and current contributors are separate pension policy issues and should be considered separately, especially as different groups of people are involved. There is no obvious direct means of assessing the appropriate balance between these policies, and each should therefore be considered on its merits.

Options Examined

6.9 As part of the NPR, the Board chose five pension systems to be examined. It is very important to emphasise that these systems were chosen solely to ensure that a wide range of alternatives would be examined. The choice of systems did not necessarily represent the Board's preferred options and was not intended to anticipate or limit the conclusions of the NPR. It should also be borne in mind the limitations of the modelling undertaken: a considerable number of assumptions have to be made, and therefore there is limited value in modelling a number of systems that are very alike.

6.10 Five alternative systems were chosen for modelling and for comparison with the current system. The section below outlines the systems and some relevant issues:

Alternative 1

- 6.10.1 This system is similar to the current pension system except that income tax relief on supplementary pensions would be available at the higher rate for all contributors, i.e. for lower rate and non-taxpayers as well as for those on the higher rate. For modelling purposes, the relief was assumed to be given as a tax credit rather than a matching contribution.

In order to model the results, an assumption had to be made of the effect that this change would have on pension take-up. The Board decided to examine the effect of a 10% increase in coverage among those affected (i.e. lower rate and non-taxpayers). This increase is not a prediction or estimate, but allows the effects of other rates of increase to be estimated relatively easily.

Alternative 2

- 6.10.2 This modelled a pension system that required mandatory pension contributions to be paid to a financial institution for earnings between the current PRSI threshold and twice GAIE. Voluntary contributions would be permitted in addition.

A contribution rate of 10% of relevant earnings was modelled, split 50:50 between contributors and their employers. This split was used only as a basis for modelling, and allows the effects of other splits to be estimated easily. The 10% contribution rate was also chosen to make estimation of alternatives straightforward, but also as being typical of what the contribution rate under a system might be. It should be noted that such a rate is not expected to meet the NPPI adequacy targets.

Alternative 3

- 6.10.3 This alternative was similar to alternative 2 described above, but assumed that the mandatory contributions were paid to a State defined contribution arrangement.

Alternative 4

- 6.10.4 This modelled a mandatory State system which paid benefits based on participants' average career earnings. The relevant earnings were as for alternative 2 above, and as before, the contributions were assumed to be split equally between employees and employers. The contributions were regarded as separate from the PRSI system.

The rate of contribution was calculated by the consultants to equal the long-term cost of the benefits provided. This is the only one of the alternatives examined which provided a benefit close to the NPPI adequacy target for a substantial additional number of participants.

Alternative 5

- 6.10.5 This model examined the effect of increasing the OACP to 50% of GAIE. The model assumed that there would be a resulting fall in membership of voluntary supplementary schemes among the lower paid.

The contribution rate required to fund the additional benefit (taken as the long-term cost) was calculated separately from current PRSI contributions.

- 6.11 The Board commissioned a report from LS/ESRI on the five pension systems chosen. This report formed an important part of the considerations of the NPR, and was intended to provide a quantitative and qualitative assessment of the current pension system and of a number of alternative pension systems. The assessments included both financial projections of costs and benefits as well as an assessment of the economic effects of the alternatives examined. The report is reproduced in full in Appendix 6 of this report.
- 6.12 The Board sees the LS/ESRI report as a valuable input not just to the NPR, but to the national debate about pension provision. It illustrates the many complexities of pension systems and the challenges of making changes. This section does not attempt to summarise the report's results in their entirety, but what follows is a synopsis of some of the most significant results.

Level of coverage

6.12.1 Each of the systems modelled was assumed to have an effect on coverage. Table 6.1 below shows the projected long-term rates of coverage for each of the systems. The rates are expressed as a percentage of those at work aged over 30 – it should be recalled that the NPPI coverage long-term target for this group is 70%.

Table 6.1 – projected long-term coverage rates

Current	60%
Alternative 1	64%
Alternative 2	72%
Alternative 3	72%
Alternative 4	72%
Alternative 5	26%

The coverage rates for alternatives 1 and 5 reflect the assumptions made: under alternative 1, it was assumed that the coverage rate among lower rate and non-taxpayers would increase by 10%; under alternative 5 it was assumed that, because of the higher first pillar benefit, no new low and medium earners would join second pillar arrangements.

The coverage rates in the mandatory systems 2, 3 and 4 are less than 100% because these systems exclude those earning less than the current PRSI threshold of €14,976 p.a.

Replacement rates

6.12.2 Each of the modelled systems will result in a different pattern of retirement income depending on earnings. The figures shown in table 6.2 below are the projected pre-retirement income replacement rates including both first pillar and second pillar pensions for someone with 40 years service at retirement. Thus on the first line, someone earning 50% of GAIE can expect a post-retirement income of 68% of their pre-retirement income. The calculations have assumed unisex annuity rates at retirement.

Table 6.2 – projected retirement income replacement rates

	Earnings (as % of GAIE)			
	50% GAIE	100%GAIE	200% GAIE	300% GAIE
Alternative 2	68%	42%	29%	19%
Alternative 3	68%	43%	31%	20%
Alternative 4	68%	55%	47%	32%
Alternative 5	100%	50%	25%	17%

Note that the figures shown for alternative 5 are for first pillar benefit only. The projections for the other systems exclude any possible voluntary top up to the mandatory system.

Alternatives 2 and 3 are defined contribution systems, so the actual results would depend on the investment returns achieved.

The replacement rates for systems 2, 3 and 4 fall as incomes increase because of the upper limit to mandatory contributions.

Supplementary contributions, % of GNP

6.12.3 The best measure of the cost of each of the systems is the total contribution, and this is shown in table 6.3. This table shows the projected total costs for each of the supplementary systems, including employer and employee costs, expressed as a percentage of GNP. The figures do not include PRSI contributions, public service benefit costs, existing public service employee contributions or proposed public service employer contributions.

Table 6.3 – contribution costs, % of GNP

	2006	2016	2026	2036	2046	2056
Current	3.0%	3.3%	3.2%	3.1%	2.9%	2.9%
Alternative 1	3.1%	3.4%	3.4%	3.3%	3.1%	3.0%
Alternative 2	3.3%	3.5%	3.6%	3.4%	3.0%	2.9%
Alternative 3	3.3%	3.5%	3.6%	3.4%	3.0%	2.9%
Alternative 4	5.2%	5.6%	5.5%	5.5%	5.3%	5.2%
Alternative 5	4.8%	4.9%	4.9%	4.7%	4.3%	4.3%

The contributions include contributions to voluntary top-up schemes for alternatives 2, 3 and 4. The contributions also include the cost of increasing the OACP for alternative 5.

The above contribution rates can be expressed as a percentage of total workforce earnings. The results are as follows:

Table 6.4 – contribution costs, % of earnings

	2006	2016	2026	2036	2046	2056
Current	7.0%	7.2%	7.4%	7.1%	6.8%	6.7%
Alternative 1	7.0%	7.6%	7.8%	7.5%	7.2%	7.1%
Alternative 2	7.6%	7.8%	8.1%	7.8%	6.9%	6.9%
Alternative 3	7.6%	7.8%	8.1%	7.8%	6.9%	6.9%
Alternative 4	12.0%	12.4%	12.5%	12.6%	12.3%	12.2%
Alternative 5	10.9%	10.8%	11.1%	11.0%	10.0%	10.0%

It is worth noting that the costs of alternative 4 shown above would be similar to the costs of achieving the NPPI supplementary coverage and adequacy targets, whether through a voluntary or supplementary system.

It is useful also to show the above contribution costs as monetary amounts, and these are shown in table 6.5:

Table 6.5 – projected 2006 contribution costs

	2006 costs (€ bn.)
Current	4.27
Alternative 1	4.30
Alternative 2	4.65
Alternative 3	4.65
Alternative 4	7.34
Alternative 5	6.72

Exchequer costs

6.12.4 The total net cost to the Exchequer of each system is shown below as a percentage of GNP:

Table 6.6 – Exchequer costs, % of GNP

	2006	2016	2026	2036	2046	2056
Current	2.5%	4.0%	5.6%	5.9%	6.3%	7.0%
Alternative 1	2.6%	4.2%	5.8%	6.0%	6.6%	7.2%
Alternative 2	3.0%	4.6%	6.2%	6.5%	6.7%	7.3%
Alternative 3	3.0%	4.6%	6.2%	6.6%	6.8%	7.4%
Alternative 4	4.1%	5.3%	6.6%	6.8%	6.9%	7.3%
Alternative 5	4.0%	5.6%	7.2%	7.4%	7.0%	7.1%

For reference, each 0.1% of GNP in 2006 is approximately €135 million.

These figures, though important, need to be treated with a great deal of caution. In particular, the following points should be noted:

- For the current system, the figures shown represent the projected PAYG cost to the Exchequer i.e. the costs of providing first pillar and public service pensions and of supporting the voluntary second pillar. In addition the net flows to or from the Exchequer in relation to the NPRF are included
- For each of the alternative systems, the figures shown represent the projected annual cost to the Exchequer, adjusted for the features of the system in question. In this regard it should be noted that the additional mandatory systems and the increase in the first pillar pension are assumed to be operated on a funded basis, and the figures reflect this assumption
- The Exchequer cost shown includes an item, in relation to the cost of supporting the voluntary second pillar, representing the tax foregone on investment income. As the LS/ESRI report points out, it is arguable whether this is a real cost, particularly for alternatives 2 and 3. A good case can be made that the methodology used overstates the Exchequer cost of those systems by an amount increasing to 0.4% of GNP in 2056.

Economic effects

6.12.5 Below are shown some of the LS/ESRI's estimate of the economic effect of each of these systems. These figures should be read in conjunction with the commentary in the report.

Table 6.7 – projected change in GNP

	Year 1	Year 5
Alternative 1	Minor	
Alternative 2	-0.07%	-0.06%
Alternative 3	-0.07%	-0.06%
Alternative 4	-0.55%	-0.51%
Alternative 5	-0.44%	-0.40%

Table 6.8 – projected change in unemployment rate

	Year 1	Year 5
Alternative 1	Minor	
Alternative 2	+0.09%	+0.06%
Alternative 3	+0.09%	+0.06%
Alternative 4	+0.74%	+0.47%
Alternative 5	+0.58%	+0.37%

The above are expressed as a percentage of the workforce. For reference, each 0.1% represents 2,000 people.

Table 6.9 – projected change in consumer prices

	Year 1	Year 5
Alternative 1	Minor	
Alternative 2	-0.17%	-0.10%
Alternative 3	-0.17%	-0.10%
Alternative 4	-1.42%	-0.84%
Alternative 5	-1.12%	-0.66%

Table 6.10 – projected change in wages

	Year 1	Year 5
Alternative 1	Minor	
Alternative 2	+0.13%	+0.15%
Alternative 3	+0.13%	+0.15%
Alternative 4	+1.07%	+1.23%
Alternative 5	+0.84%	+0.97%

Assumed impact on existing provision

6.12.6 Below is the Board's view of the expected impact of each of the systems on current voluntary supplementary provision:

Alternative 1	Little or none
Alternative 2	In the medium term, provision above the mandatory level is unlikely except for high earners
Alternative 3	As for 2
Alternative 4	Supplementary provision will be rare and confined to high earners
Alternative 5	Supplementary provision for low to medium earners will decline. Provision for medium and higher likely to be unaffected, though the rules of integrated schemes will result in some benefit reduction.

Criteria

6.13 In order that consideration of alternative pension systems be as ordered and structured as possible, a set of criteria was agreed against which any system being recommended could be assessed.

- 6.14 Below are the criteria considered when assessing whether a particular pension system (first and second pillar) would be suitable for Ireland. These criteria apply both to the level of pension provided under the system and the means of delivery. Many of the criteria interact with each other and it will therefore not always be possible to consider them separately. Furthermore, depending on the particular system being assessed some criteria may be less applicable than others. For example, in examining a mandatory system coverage is likely to be less of an issue than cost.

The criteria are:

1. Coverage
2. Adequacy
3. Cost
4. Simplicity
5. Continuity
6. Modernisation
7. Redistribution
8. Competitiveness
9. Choice
10. Robustness
11. Acceptability

Coverage

- 6.15 In terms of coverage the assessment is whether or not the system is likely to achieve the intended coverage targets. The assessment should not be a single aggregate measure of coverage, but should also take account of inclusiveness. In particular, it should ensure that there are no unintended exclusions. In this regard it is important to focus on the breakdown of the original NPPI coverage targets referred to in table 4.1. Any measure of coverage should ensure that the coverage that does exist is related to those groups where coverage is of particular importance, i.e. on lower and middle incomes, particularly women, and those in the private sector.

The remit of the NPR specifically refers to female coverage as an issue to be addressed.

Adequacy

- 6.16 Adequacy is an assessment of whether or not the replacement incomes provided by the system will meet the target amounts. As for coverage, adequacy should take account of inclusiveness.

Any assessment of adequacy should take account of the time required to achieve it. Where a pension system's benefits are related to a period worked and/or earnings, there will be an interim period before participants will have accumulated maximum potential benefits – this could be as long as a full working lifetime.

Cost

- 6.17 Cost is a measure of how much the system will cost the individual, the Exchequer and the employer where relevant. The aggregate cost of benefits is the combination of adequacy and coverage, plus administration costs.

The other cost issue is who pays. This can be any combination of the employer, employee/individual and Exchequer. The division of cost has impacts on other areas such as pay structures, employment, competitiveness and the overall allocation of tax revenue.

A related issue is sustainability, i.e. the progress of cost over time and its affordability. The extent to which a system is funded will affect the incidence of cost but is unlikely to substantially change the total cost.

Where the system under consideration differs from the current system, there will be changeover costs. The total cost of a pension system can only be divided among direct employer costs, direct employee/self-employed costs and Exchequer costs. The efficiency of a pension system can be measured by the percentage of contributions that are absorbed by record keeping. This is related to the complexity of the system and to the number of separate arrangements involved. The more systems in place and the more complex the interactions between those systems, the higher the proportion of contributions that will be required to administer the systems.

Simplicity

- 6.18 Simplicity is the measurement of how clearly the participants understand their pension provision. Simplicity is clearly related to the predictability of the benefits provided by the system. This may differ between first and second pillars. Note that participants may not understand even a simple system if they do not read the information provided.

Related to simplicity is administrative complexity, which in turn will affect costs.

Continuity

- 6.19 Continuity is an assessment of whether the system being examined is similar to the current system and whether any changes can be reasonably easily accommodated. Given the very long-term nature of pensions, continuity is extremely important. Any change has the potential to cause changeover costs and make the resulting benefits more complex and therefore impact on cost and simplicity. Discontinuity may give rise to anomalies of coverage or adequacy and to loss of confidence.

The issue of continuity is not likely to be the main issue in deciding on an appropriate system, particularly where there are other criteria that favour an alternative to the current system. In this scenario the issue of continuity needs to be considered as part of the implementation of a new system.

Modernisation

- 6.20 The EU defines modernisation of a national pension system as to how well it facilitates labour mobility and flexibility. Obviously any system chosen should not restrict labour force mobility or flexibility.

Redistribution

- 6.21 This is the assessment of how closely benefits provided match contributions made for and on behalf of the participant. Broadly speaking, first pillar pension arrangements are often deliberately redistributive, whereas second pillar arrangements do not aim for redistribution. However, not all redistribution is intentional.

Redistribution may occur between generations, and/or between income groups. Income group redistribution may be progressive (i.e. favour lower earners, as for the first pillar system) or regressive (i.e. favour higher earners).

Competitiveness

- 6.22 This is an assessment of how a system being considered is likely to impact on individual employer competitiveness or the competitiveness of the economy as a whole.

Choice

- 6.23 This is an assessment of how much choice a system will allow to individuals both in terms of participation and in terms of how benefits can be paid.

Robustness

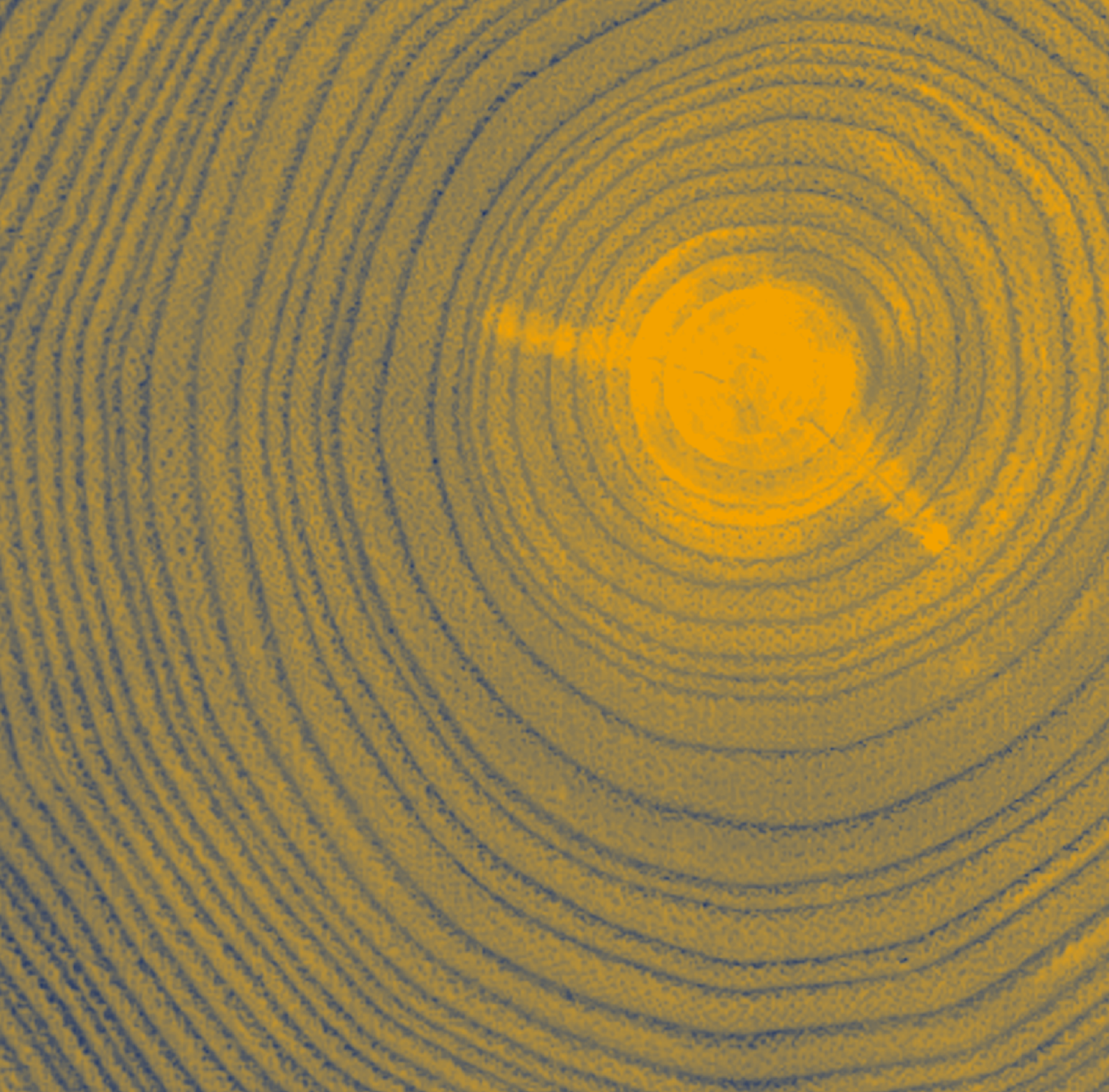
- 6.24 Any system being considered must be robust enough to deal with future events.

Acceptability

- 6.25 This is an assessment of how likely it is that a pension system will gain the support of those groups necessary to its successful implementation.

Acceptability is considerably influenced by the current pension system. The current pension system may have implicit commitments and assumptions, in particular the link between PRSI contributions and pension entitlements, and the tax treatment of supplementary pension contributions.

Any system should have the confidence of the participants. All of the criteria will impact on this.



CHAPTER 7

ENHANCEMENTS TO THE SUPPLEMENTARY SYSTEM

CHAPTER 7 – ENHANCEMENTS TO THE SUPPLEMENTARY SYSTEM

Overview

- 7.1 The submissions to the NPR included a considerable number of suggested changes to aspects of the current voluntary second pillar system, and this chapter examines a number of these suggestions.

The Board recommends the adoption of a number of these proposals, and these are identified in section 7.42 below.

The second pillar system is extremely complex, as are the reasons why many of those in the workforce do not have adequate, if any, coverage. The Board is well aware that no single change to the current voluntary system will on its own achieve the NPPI targets. Although the analysis below reflects this, it should be borne in mind that, nonetheless, the cumulative effect of a number of the proposals may make a significant difference.

Introductory comments

- 7.2 Because of the number of submissions, and the similarity of many of the suggestions, this section has grouped potential enhancements into a smaller number of categories. These categories are:

- Tax and related incentives
- Special Savings Investment Accounts (“SSIAs”)
- PRSAs and related issues
- Other proposals

- 7.3 Almost all of the suggested enhancements potentially involve some additional Exchequer cost. In considering this, it is necessary to distinguish between the Exchequer cost (in the form of tax reliefs) that will be incurred automatically if any progress is made towards the NPPI targets and other additional costs. In this section, only the additional Exchequer costs are considered.

Tax and related incentives

“Higher Rate Tax Relief”

- 7.4 The first incentive considered was the proposal to make tax relief available to all at the higher rate of 42%, rather than at each individual’s marginal rate. This proposal would include a refundable credit to those not in the income tax net.

Background

- 7.5. This proposal is intended to address a number of perceived issues with the current tax reliefs for supplementary pensions:
- The extent of coverage decreases with income: the lower the income, the less likely a person is to have supplementary provision. CSO household budget data show that the lower a household’s income, the smaller the percentage of income that is used for pensions and savings. Changes to the current system should therefore be focused on these groups. In addition, the availability of higher rate tax relief will be a visible incentive

- Because the support for supplementary pensions is given through tax relief, there is less incentive for those in lower tax bands than for higher rate tax-payers
- Irrespective of what this change would contribute to the achievement of the NPPI targets, some believe that this should be introduced to correct a perceived inequity in the current system.

Potential advantages and drawbacks

- 7.6. The advantage of this approach from the point of view of achieving the NPPI targets, i.e. setting aside the issue of tax equity, is that it affects only those whom it is intended to influence. Furthermore, even if many of those concerned may not be aware of the details of tax relief or its net financial effects, this change would provide additional means to persuade potential savers of the benefits of pensions.

This change is based on the assumption that the reason that so many in lower income groups do not save is value for money. It presumes that many of them have assessed the return on pension savings and found it unsatisfactory: it further assumes that the proposed change will be enough to change that assessment.

A considerable number of people in this category nonetheless must not be making pension contributions because they cannot afford to, or at least perceive they cannot. Some further number may have decided that the first pillar pension will provide adequately for them. There may be some further number who have savings outside the second pillar system, but the Board believes that this will be comparatively rare among lower rate taxpayers.

Any increase in coverage as a result of this measure would depend on the success of convincing this group of the merits of pensions because of the higher tax relief. The success of the measure would therefore depend on the economics of selling pensions to the lower paid – something that is currently in considerable doubt in the industry.

There is concern among some people that this change would have a significant deadweight factor, i.e. that the greater part of the cost of this change (which is the cost of the additional tax relief) would be incurred in respect of people who already are making or would have made pension contributions in any case. On the other hand, it is felt that it would not be practical or equitable to limit this benefit to those who are not already saving for retirement.

Cost

- 7.7. Alternative 1, modelled in the LS/ESRI report, looked at the effects of this change. The modelling assumed that there would be an eventual increase of 10% in the coverage of lower rate and non-taxpayers, though it is important to restate that this assumption was not a prediction. The model estimated that the increased cost would be about 0.2% to 0.3% of GNP per annum, or about €250 million to €400 million in 2005 terms.

“Tax Credit/Matching Contribution”

- 7.8. A significant number of contributions to the NPR process have proposed that the incentive for supplementary pensions should be provided by means of a partial contribution match (as for SSiAs) rather than as tax relief. Under this proposal, pension contributions would be made from after tax income, but the Exchequer would add a matching contribution to the pension investment made each year.

Almost all of the submissions proposed a matching contribution rate that would be the same for all contributors rather than depending on their individual marginal income tax rates. The effect of such an approach would be to combine the advantages of the SSiA approach with improved equity for all taxpayers.

Not all of the proposals specified the rate of matching, and there was some variation among those that did. The following figures illustrate the range of possibilities:

- To equal the financial effect of tax relief at 42%, the matching contribution rate would be 72.4%, i.e. for each €1 contribution by the taxpayer, an additional 72.4c would be added by the Exchequer
- If allowance is made for PRSI and health levy as well as income tax, a higher matching contribution would be appropriate. For instance, adding the 2% levy would increase the matching contribution rate from 72.4c to 78.6c. Many higher rate taxpayers would not be receiving PRSI relief on pension contributions as their earnings would exceed the ceiling, so an allowance for PRSI relief may or may not be appropriate
- Employer PRSI contributions are not payable on employee pension contributions. If pension contributions were made from after tax payments, the Exchequer would therefore receive additional PRSI revenue. If allowance for this is made in the matching rate, the rate for top-rate taxpayers could be increased from 78.6c to €1.21
- The corresponding rate for a lower rate taxpayer would be 58.1c. This rate allows for 20% income tax, 4% employee PRSI, 2% health levy and 10.75% employer PRSI.

The rate chosen depends on whether this proposal is intended to be revenue neutral or not. The proposal in 7.4 above is specifically intended to provide additional incentives to the lower paid, and is not revenue neutral. If this approach were followed, the appropriate matching rate would be slightly above €1.21, depending on what allowance is included for employee PRSI relief. If the system was intended to be revenue neutral, the appropriate rate would depend on the assumed mix between higher and lower rate taxpayers: this assumption would have to take account of the effect of this change on the balance. One submission suggested a matching rate of 66c, i.e. €2 for every €3 invested. However, this would seem to represent a significant reduction in the support for higher rate taxpayers.

It is not proposed that the treatment of employer contributions to pension schemes be changed: these would continue to be allowable as a business expense in the normal way.

Background

- 7.9 This suggested change to the means of granting tax relief is based on the success of the SSIA structure where the Exchequer subsidy was paid in a very straightforward and transparent way. The success of SSIA's is believed to be due in large part to this approach.

There is anecdotal evidence that many do not understand the mechanism whereby tax relief is allowed on pension contributions: some employees apparently do not realise they are receiving tax relief, and many others may not appreciate the value of it. Were the relief allowed using the SSIA model, it is believed that many more would understand the value and some contributors who are not currently claiming tax relief would receive it. Such an approach would give a strong impetus to the efforts to increase coverage.

This proposed change also incorporates the arguments made above in favour of granting tax-relief at or close to the top rate of tax.

Potential advantages and drawbacks

- 7.10 There is widespread agreement that this proposal would greatly increase the awareness of the existence of and the value of the State's support for supplementary pensions. This would result in a higher number of people initiating pensions, but, perhaps more importantly, would make many people be more receptive to pensions initiatives.

If the rate of contribution matching incorporated an increase in support for pension savings by those on lower tax rates, the comments in 7.6 above would apply.

The success of this approach among those on lower incomes depends as before on the economics of selling pensions to that group. Although this proposal will undoubtedly make potential contributors more receptive, this may not be enough to make this activity profitable enough to achieve the coverage increase needed.

If pension contributions are to be paid out of after tax income, employers would lose the PRSI saving they currently make on such contributions, and would therefore face increased costs, though this will rarely be more than 0.5% of payroll before tax. However, it should be noted that many people feel that the current situation, whereby the employer benefits if the employee contributes, is illogical, particularly where the employer is not making any contributions.

Under current Revenue Commissioners' rules, the amount of tax relief available on personal (rather than employer) contributions depends on age. Were the tax relief system replaced by a contribution credit, a different approach would have to be found if it was decided to retain an age-related differential.

Cost

- 7.11 It is clearly difficult to estimate the cost of this, as the take-up would depend on the extent to which it changed attitude to pensions. The cost would also depend on the rate of contribution matching that was adopted. However, the only additional Exchequer cost, i.e. costs over and above the current rate of tax incentive available, would be the cost of providing additional relief to lower rate tax-payers. Based on the calculations described in 7.7 above, a cost of approximately 0.4% of GNP might be estimated.

SSIAs

"Capture SSIA Savings"

- 7.12 There have been a variety of proposals made to encourage holders of SSIAs to convert their savings into pensions, and/or to continue the contributions they currently make to SSIAs into a pension.

This section looks at the proposals to 'capture' the SSIA savings already accumulated. The main suggestions made have been:

- Waive exit tax – SSIAs are subject to a tax of 23% on investment profits
- Waive pension contribution limits (possibly subject to conditions) – the total proceeds of the typical SSIA are in most cases greater than the contribution allowable for income tax in that year
- Additional incentives (particularly for lower paid) – if SSIA funds are invested in a pension plan, the holder will qualify for tax relief, subject to Revenue Commissioners' limits. A number of proposals have suggested additional incentives, the most notable of which would allow top rate relief to all, irrespective of their own marginal rate.

Background

- 7.13 SSIA take-up was considerably higher than expected. The data about income and ages of SSIA holders show that in many cases they are from those groups with relatively low pension coverage, which seems to indicate that SSIAs have succeeded where the pension savings message has not been effective. However, now that so many have demonstrated to themselves that they can afford to save successfully, they may be willing, given the right incentives, to convert that habit into retirement savings.

The Indecon Report included an analysis of various options for attracting SSIA savings, and readers are referred to that report (Appendix 8) for a more complete analysis.

Potential advantages and drawbacks

- 7.14 The broad argument in favour of SSIA incentives is the fact that this is a group proven to be susceptible to incentives to save.

It can be argued that allowing a once off increase in contribution limits does not result in any real additional cost to the Exchequer. Even if the SSIA proceeds are more than the tax relief allowable in the year in which the pension investment is made, the taxpayer has the right to claim the excess tax relief in future years. Allowing it all in one year advances the receipt, and is likely to be effective as an incentive gesture, but will not increase the taxpayer's entitlements except in a tiny minority of cases.

A number of surveys have indicated interest among a high proportion of SSIA holders in continuing to save and to invest the proceeds of their SSIA.

A number of arguments have been made against SSIA incentives. Broadly speaking, they tend to be about equity or effectiveness.

SSIA savers have already benefited from a valuable Exchequer subsidy. Although data show SSIA holders are held by people of all income levels, there is nonetheless a bias towards higher earners. Any SSIA incentive that is not limited to lower earners can be argued to be inequitable and biased towards higher earners. It will also be inefficient at targeting the NPPI priority groups.

Anyone who transfers all or part of their SSIA proceeds into a pension will receive an additional incentive in the form of the existing tax relief in any event. It is not clear why any further incentive over and above this is needed. If the existing incentive is ineffective, it is likely that an additional incentive would be equally ineffective. If people are not aware of the current incentive, it would be more efficient to publicise it (or to recast it into a more obvious form, such as a contribution match) rather than add to it.

SSIAs were available for a limited period of time, and almost 50% of SSIA holders were set up in the month before the closing date. The 5 year term of SSIA holders is considerably shorter than for retirement savings, and there is no restriction on the payment or use of the proceeds of SSIA holders. Many people will by now have made specific plans for the proceeds of their savings. All of these have been advanced as arguments why SSIA holders are different to pensions and why incentives to put the proceeds into pensions will only succeed for those who would have done so anyway.

Cost

- 7.15 It is difficult to estimate the cost of this, as it would be dependent on the level of take-up. Readers are referred to the Indecon Report in Appendix 8 where there is further analysis of this proposal.

PRSAs and related issues

"PRSA Regulation"

- 7.16 The Board received a number of submissions to the NPR calling for a reduction in the amount of regulation to which PRSAs are subject. Among the specific points made were:

- PRSA sales are subject to considerably more regulation than many non-pension investments, such as property or many banking or insurance contracts. The amount of this regulation does not seem to bear any relationship to the perceived risk of loss or mis-selling
- PRSAs are subject to considerably more regulation at point of sale, disclosure obligations and product supervision than any other pension product. In particular, it is notable that PRSAs are the only pension vehicle subject to product approval: although this should result in a lower level of sales regulation, the opposite is actually the case.

Specific proposals on PRSA regulation have been made that the fact-finding questionnaire at point of sale should be eliminated, and this is discussed below.

Background

- 7.17. The administration and sales of PRSAs are subject to regulation by the Board, the Revenue Commissioners, and the Financial Regulator. The Board has a statutory responsibility for approving the product design and materials, for supervising the ongoing compliance with the Pensions Act and for gathering data in relation to contracts opened. The Revenue Commissioners also approve the product jointly with the Board, and are entitled to collect data from providers. The Financial Regulator has a statutory responsibility for supervising the sale of the products.

PRSAs were intended to be an important part of the strategy to achieve the NPPI targets (though it should be noted that they were never intended to be the sole means). However, although no specific take-up targets were set, the increase in coverage since the NPPI recommendations began to be implemented is not significant, and the sales of PRSAs have been slow.

PRSA providers have cited the regulatory burden as a significant contributory factor to the low sales. They say that potential savers find the compliance requirements discouraging. Intermediaries also find that the regulatory requirements make these products uneconomic to sell, especially for smaller contributions, which is where the PRSA was meant to be especially relevant.

The PRSA legislation was drafted before the Financial Regulator was set up, and envisaged that PRSAs would be subject to a high level of product approval and a correspondingly lower need for point of sale supervision. However, the final regulatory regime differs from the original intention.

The view has been expressed that an investment in a PRSA should be subject to minimal if any point of sale fact-finding. A comparison is drawn with saving through an OPS or additional voluntary contributions ("AVCs"): in these cases, there is no obligation to provide illustrations, disclose charges, get Personal Public Service ("PPS") number information or perform a financial fact-find, despite the fact that there are no legal constraints on the charges or product design.

Potential advantages and drawbacks

- 7.18. The primary advantage of reduced regulation will be in the indirect incentive this provides for intermediaries and providers to make additional marketing and distribution efforts to sell PRSAs. This is consistent with the general view that pensions need to be sold: there is unlikely to be a significant self-motivated demand for pension savings products.

As well as providing additional incentives to those selling these products, a reduction in regulation will make the process less off-putting for those who are considering setting up a PRSA. There are some aspects of the current regulation, particularly the obligation to provide a PPS number, that impose a delay on the signing up process and provide an additional opportunity for it to fail.

A more general observation is that regulation should correspond to and aid policy. The policy in this case is that PRSAs, especially Standard PRSAs, should be encouraged, that increased pension saving is a policy goal and that the approval process for PRSA products should allow the less financially informed to invest with more confidence. However, the perverse outcome has been an increase in regulation and a resulting disincentive to pension coverage.

PRSA regulation undeniably reduces the possibility of someone starting or continuing a PRSA where it is unsuitable or not appropriate for their particular circumstances. Although this possibility may be small, any reduction in regulation will increase it. However, it should be noted that the Board do not see this risk as significant.

Cost

- 7.19 This proposal is expected to have little or no long-term cost.

"PRSA Charges"

- 7.20 One suggestion made was to increase the maximum charges permitted under Standard PRSAs. A separate submission proposed that the per-contribution Standard PRSA charge be eliminated, and replaced by a higher annual fund charge.

Background

- 7.21 The proposal to increase the maximum permitted charges is intended to make the sale of PRSAs more economic for providers and intermediaries, and is based on the assumption that the advantages of the additional margins in generating additional sales will outweigh the drawbacks of higher charges.

The proposal to rebalance contribution and fund charges is intended to deal with the perceived resistance to the current charging structure.

Potential advantages and drawbacks

- 7.22 Larger margins on PRSAs would undoubtedly lead to more sales efforts.

The rebalancing of PRSA charges recognises the fact that people tend to prefer fund charges to contribution charges, or, put another way, tend to be less aware of fund charges.

Higher Standard PRSA charges will mean poorer returns for savers. Furthermore, in order to make a significant impact on the sales of PRSAs, a significant increase in charges is likely to be necessary. This would be especially true in respect of small contribution sales to lower earners. Higher charges will also weaken the argument for lightening the regulation on the sales of these products.

The proposal to rebalance charges is only worth pursuing if there is evidence that the current structure is a significant disincentive. However, the Board has received no such evidence. The proposed rebalancing would also reduce the providers' margins in the early years of these contracts, making them less attractive to provide.

Cost

- 7.23 Neither of these proposals would have any Exchequer or regulatory cost. The proposal to increase maximum Standard PRSA charges would increase costs for some PRSA savers.

Other proposals***"Access to Funds"***

- 7.24. A considerable number of submissions to the NPR proposed that pension savers should be allowed to withdraw some portion of their savings before retirement.

The proposals differed in their details: some of the suggestions included early withdrawal as part of a composite proposal. Among the different suggestions made were:

- Some proposals would only permit withdrawals for specified purposes, such as education costs or the purchase of a house. Others proposed no such restrictions
- A number of different tax treatments was suggested. Some suggested that withdrawals should be subject to income tax, others that they should be tax free. One proposal suggested a model that in effect offset tax-free withdrawals against the tax-free allowance at retirement
- All of the proposals differed in the ages or periods after which withdrawals could be made and the amounts that could be withdrawn. However, these differences are not significant in the context of the NPR.

It is estimated that there are over €60 billion of accumulated pension assets including OPSs, PRSAs and RACs. There seems little doubt that if individuals were allowed access to part of these funds, there would be a considerable outflow in a short period of time. It would therefore be necessary to limit this facility to funds accumulated after its introduction. It would also be impractical to make a withdrawal facility available for defined benefit schemes.

It was not proposed in any of the submissions that members of OPSs be permitted to withdraw contributions made by employers.

Background

- 7.25 Many people cite the long-term nature of pension savings as a significant reason why many choose not to save for retirement, or fail to avail of the tax supports for pension savings. These proposals suggest that if people are allowed to access some of their pensions savings, the remaining amount that they save for retirement will nonetheless be greater than it would otherwise have been, i.e. had they not saved at all.

Potential advantages and drawbacks

- 7.26 The advantage in this proposal is that the commitment required to pension savings would be less, and people would be able to begin and continue pension saving in the knowledge that if their circumstances change in the future, they can access at least part of their assets. From an individual's point of view, this facility would make savings more efficient, as there would be less need to separate retirement savings from other shorter term savings.

In the Finance Act, 1999 holders of RACs and some members of OPSs were permitted to access part or all of their retirement savings at retirement through the introduction of Approved Retirement Funds ("ARFs"). In the years that followed, there was a significant increase in the volume of pension contracts sold. It is the view of the pensions and insurance industry that the increase was a direct result of the introduction of ARFs, and that this broadly demonstrates the net benefits of allowing access to funds.

There is a view that the advantage of this facility is more to do with the perception than actual usage, and that the positive effects would outweigh the negative effects of actual withdrawals.

The greatest concern about this proposal is the effect it may have on the adequacy of retirement incomes. The intention of this change would be to attract many of those without retirement savings to begin saving. The risk is that many who are already contributing towards a pension will take advantage of this facility with the effect of reducing their retirement provision: this would be an issue particularly for those in compulsory schemes. There is therefore a trade-off between coverage – new savers attracted by the more flexible requirements – and adequacy – existing savers reducing what are in general already inadequate pensions.

Underlying this suggestion is the assumption that people are willing to save, but are discouraged by the restrictions imposed on formal pension savings. However, were this true, one would expect significant amounts of saving to be taking place outside the formal pension system. This is discussed elsewhere in this report, but there is certainly no evidence that this is taking place among the key groups of the lower paid, those in irregular employment and women.

There is the possibility that the result of this change would be to bring existing third pillar savings into the second pillar system, but in the process create little net new saving. This process may explain the increase in pension savings seen after the introduction of ARFs: the emergence in recent years of property investment through pensions and associated borrowing can then be seen as a reclassification of savings that would have occurred in any case rather than genuine new savings. All savings are to be welcomed, but given the possibility of undermining the adequacy of existing pension savers, to be justified, this change would need to be likely to encourage net new savings.

Cost

- 7.27 The cost to the Exchequer of allowing access before retirement depends on the taxation treatment of any such withdrawals. It also depends on how much of additional savings are new rather than redirected savings, and how much withdrawals are made from existing contributions:
- If withdrawals are subject to tax, the effect may be to advance tax receipts to the Exchequer that would otherwise have been delayed until retirement. Such withdrawals would also reduce in some cases the amount of tax free cash available at retirement
 - Allowing withdrawals free of tax would represent a tax loss to the Exchequer. Clearly pension vehicles which allow such withdrawals would be very attractive, and likely to divert funds away from other forms of taxed savings
 - If tax free withdrawals are offset against retirement tax free cash, the broad effect is likely to be tax neutral for existing contributions, but the issue of redirected savings remains.

“Pension Accounts for Children”

- 7.28 A number of submissions proposed that savings accounts could be established for children with the benefit of an Exchequer subsidy. A fixed proportion of the proceeds of these accounts would be available at a stipulated age (25 has been suggested) while the balance would be used to provide a pension at retirement. The proposals envisage a set payment for every child into a special account, and a partial match by the Exchequer of further contributions made on the child’s behalf.

Background

- 7.29 The background to this proposal is the increasing life expectancy of recent years, which is expected to continue to increase. One response to the cost of longer retirement is to increase the period of retirement savings.

A further intention of this proposal is to foster an awareness of the need for retirement savings among the young, and to create a savings habit. It is a part of these proposals that it be linked with an ongoing education and awareness policy.

Potential advantages and drawbacks

- 7.30 This proposal would increase the amount of money being set aside for retirement, and would therefore contribute in the long-term towards the NPPI targets. The proposed information campaigns would increase pension awareness, and it would be hoped that this would further encourage pension provision.

If the initiative was successful in fostering a savings habit, it is likely that the NPPI targets could be achieved, albeit in the very long-term.

The Exchequer subsidy envisaged will only be a successful policy if those concerned continue to save after the subsidy stops. However, some have expressed doubt that saving money on behalf of a child, whether by the Exchequer, by parents or others will make that child any more likely to save when he or she begins to earn for themselves. On the other hand, it is suggested that the regular benefit statements, which are an implicit part of this proposal, are intended to build awareness of the accumulating savings and of the benefits of a savings habit.

It is more likely that higher earners would take advantage of the matching Exchequer contributions proposed. There is a risk that the beneficiaries of the cost of this scheme will therefore be those least likely to need it.

Cost

- 7.31 The cost of this proposal depends on the levels of Exchequer contribution and the take-up of the matching contribution option. One of the proposals received suggested a basic Exchequer contribution of €10 per child per month, and a maximum further Exchequer contribution of €10 per month via a 20% contribution match. The estimated first year cost would be a minimum of €130 million, and possibly up to €150 million.

A somewhat different proposal suggested a basic Exchequer contribution of 10% of the monthly rate of Child Benefit – i.e. €15 per month - with a facility for matching contributions by parents/grandparents/ etc, tax-relieved but with a maximum of, say, 3 or 4 times the Exchequer contribution. This proposal suggested phasing in over a 17-18 year period, and setting up the accounts only for children for whom Child Benefit is payable for the first time, but paying equivalent sums to accounts for 17/18 year-olds, ie as they exit from Child Benefit eligibility. This would very substantially reduce the cost of the proposal.

“Universal ARFs”

- 7.32 It has been proposed that ARFs be made available to all pension contributors.

Background

- 7.33 ARFs are alternatives to annuities which are available to some retirees. At retirement, those qualifying for ARFs can use their retirement funds to:

- withdraw as cash, subject to tax
- invest in an ARF, and draw down at their own discretion
- purchase an annuity; or
- any combination of the above.

There are a number of restrictions on taking cash or making withdrawals from ARFs.

The only retirees not eligible for ARFs are:

- members of OPSs who do not hold or control at least 5% of the shares of the sponsoring employer; or
- holders of buy-out bonds.

Members of OPSs are eligible for ARFs in respect of any AVCs they have made.

It has been suggested that making ARFs universally available would increase the attractiveness of pension saving.

As part of the NPR, the Board commissioned a report from Hewitt Associates on retirement options and the forms in which retirement benefits could be taken. This report is included as Appendix 5.

Potential advantages and drawbacks

- 7.34 There is evidence that the introduction of ARFs from 1999 resulted in an increased interest in and contributions to supplementary retirement savings. The purpose of this proposal would be to extend the advantages and the resulting pension interest to the remaining groups currently ineligible for ARFs.

Apart from the issue of coverage, a further argument in favour of this proposal is that of equity: there is no clear reason why some members of OPSs should be excluded from ARFs which are otherwise widely available, and very popular.

There is a range of views on the advantages and disadvantages of ARFs and in particular on the current income and capital thresholds. However, they are only being considered here in the context of whether or not they can improve coverage and adequacy.

The argument against extending ARFs is that they appear unlikely to make any difference to coverage or adequacy. Anyone who does not currently have supplementary provision can begin contributions to a PRSA or RAC, both of which are eligible for ARFs. Anyone currently in an OPS and not eligible, who wishes to make additional savings, i.e. improve adequacy, will do so through a PRSA or by means of AVCs, both of which, again are eligible for ARFs.

There is some concern that availability of ARFs for all members of OPSs would put pressure on their solvency and might eventually damage defined benefit pension provision.

Cost

- 7.35 This proposal if implemented would have no significant cost implications. There may be cashflow issues for the Exchequer if members of PAYG public service schemes could withdraw the value of their benefits at retirement.

“Automatic enrolment”

- 7.36 It has been proposed that on beginning employment, all employees who do not immediately join a pension plan must, through a statutory obligation on employers, be included in a PRSA or similar arrangement, and have 5% deducted from earnings. Employees would have the right to opt out. This is potentially a soft approach to a form of mandatory provision.

Background

- 7.37 This proposal is based on the view that many people are aware of the importance of pensions and savings, but just never quite get around to it. However, it is thought that once they are signed up, they would be unlikely to opt out in many cases – there is some evidence from U.K. OPS experience and other sources that opt-out rates could be low. Furthermore, if they are signed up at the beginning of their employment, the contribution will be deducted from the start, and they will not experience any reduction in income.

Similar approaches are being adopted in New Zealand and considered in a number of countries such as the U.K.

Potential advantages and drawbacks

- 7.38 A number of studies suggest that this approach has the potential to increase coverage significantly. The persistency rates are likely to be improved if it is implemented along with the contribution matching proposal discussed above.

This proposal would require legislative change, but is considered to be relatively easy to put in place. The implementation would involve an extension of the current employer obligations. However, some modification of the current PRSA regulations would be needed so that PRSAs could be set up on behalf of contributors without requiring their consent.

Because of the large numbers of new contracts that would be set up and the resulting business for pension providers, it may be possible to reduce charges below the current Standard PRSA levels.

The successful implementation of this scheme depends on actions by employers. Although no employer contribution is proposed (and potentially, the employers would see reduced PRSI contributions as a result of employee contributions), the potential challenges should not be underestimated. In particular, the large number of employers who have been slow to comply with the less demanding PRSA access obligations should be noted: this scheme would oblige them not just to set up a PRSA facility (which is very undemanding if no employees take advantage of it) but to set up and operate contribution deductions and payments.

There is particular scope under this scheme for employers and employees to collude in avoiding their obligations by agreeing together not to make any deductions from the start. The Board recognises that this would be almost impossible to prevent or police adequately. One possible solution is to oblige all employees to make, for example, three months' contributions before they are permitted to opt out.

A result of employees opting out would be that there would be a large number of small uneconomic contracts in existence. These would be a problem for the providers: they would also be of little benefit to their owners, as they would provide no significant retirement benefits, and in many cases they would forget about their existence by the time they retire. Under PRSA legislation, small dormant contracts can be closed down by providers and the value refunded: some similar provisions might be considered.

This scheme is only practical for employees: it would be of no benefit to the self-employed. Furthermore, some thought must be given to exemptions for the lower paid, who are less well able to afford the contributions, and for whom the State pension will be sufficient to meet the NPPI replacement income targets.

Cost

7.39 This scheme would involve no direct additional Exchequer or employer cost. However, the cost and administrative burden to employers of operating a deduction system should be noted.

7.40 The Board is in favour of specific enhancements to the current voluntary supplementary system. Many members of the Board consider that further enhancements of the voluntary supplementary system can, over time, achieve significant improvements in coverage and adequacy. Although some members of the Board do not think that the proposed enhancements will achieve the NPPI targets, they nonetheless support the proposed enhancements as a means of improving the current situation.

7.41 The Board was guided by a number of factors in identifying the enhancements which it believes would be most successful in improving coverage and adequacy. These were:

- Any changes to the current system should prioritise those groups where coverage and adequacy are of greatest concern, i.e. the lower paid and younger workers. Lack of coverage among these groups is especially evident among women.
- Any suggested changes to the voluntary second pillar system must take account of the dynamics of how and why people do or do not begin pension provision. Changes must, if possible, increase the attractiveness and visibility of pensions to the target groups and any supports must be as efficient and focussed as possible.
- The maturing of SSIs is a once-off opportunity to engage a large number of people in pensions savings, both by trying to retain their funds for retirement provision and, possibly more importantly, persuading them to continue their savings habit in a pensions context.

7.42 The Board has identified the following proposals as its preferred enhancements. It is important to emphasise that these proposals are seen as a group, and the Board is of the view that most impact will be achieved if they are implemented together.

Incentive Enhancements

7.42.1 The Board recommends that the State incentive for PRSA personal contributions be granted by means of a matching contribution rather than through tax relief. The Board also recommends that these PRSA contributors be allowed a limited access to their funds before retirement:

- Personal contributions (i.e. contributions other than employer contributions) would attract a matching Exchequer contribution of €1 for each €1 contributed, subject to a maximum
- Employer contributions would continue to be treated as a business expense
- Contributors would be entitled to withdraw up to 30% of their accumulated funds tax free before age 45. At retirement after age 60, 20% of the balance could be taken tax free (rather than the current 25%).

The reasoning behind this proposal is as follows:

- The mechanism of Exchequer support by means of a contribution match rather than tax relief is widely seen as one of the factors behind the success of SSIA's. Limiting this to PRSAs minimises the structural change needed for implementation. However the Board also recommends that further consideration is given to the implementation of this for all other pension vehicles
- A flat contribution matching rate means that all tax-payers receive the same level of support, irrespective of their marginal rate
- The proposed 100% matching rate is designed to be broadly revenue neutral after taking account of employer PRSI savings
- The facility to withdraw part of the fund will make this structure more attractive to younger savers. Nonetheless, the suggested withdrawal percentages are intended to achieve broad neutrality between the earlier withdrawals and the reduction in the allowable tax-free cash sum at retirement.

7.42.2 The Board recommends that tax relief for other forms of supplementary pension provision is allowed at the higher rate for all personal contributions. This should apply through the current method of granting relief at source or through a method of refundable tax credit, where appropriate.

7.42.3 The Board recommends that the point of sale regulation of Standard PRSAs be reduced by eliminating the requirement to prepare a fact-finding questionnaire in such cases.

This recommendation is aimed at restoring PRSAs to what was envisaged in the original NPPI Report, i.e. a simple contract that, because of the contract approval requirements, could be sold or bought with minimal compliance. It is also intended to improve the economics of marketing such contracts.

7.42.4 The Board recommends that incentives be introduced to encourage the proceeds of SSIA's to be saved for retirement. These incentives should be targeted at those who would not otherwise qualify for tax relief, or who have not recently fully availed of their tax relief entitlement as follows:

- A once-off increase in pension contribution limits for individuals – this would apply to those who had not fully used their pension contribution allowances in the recent past, and would be particularly designed to encourage the transfer of SSIA funds into pension savings
- Exemption of SSIA exit tax on transfer to pensions where no income tax relief is also being claimed on the amount being transferred – this proposal would be specifically targeted at non-taxpayers, who are a priority group, but would not incur potentially high costs in respect of other taxpayers.

Some recent surveys suggest that many SSIA holders are open to the idea of retaining their SSIA savings rather than spending them. These proposals aim to encourage this, but without providing incentives above and beyond the current maximum contribution reliefs.

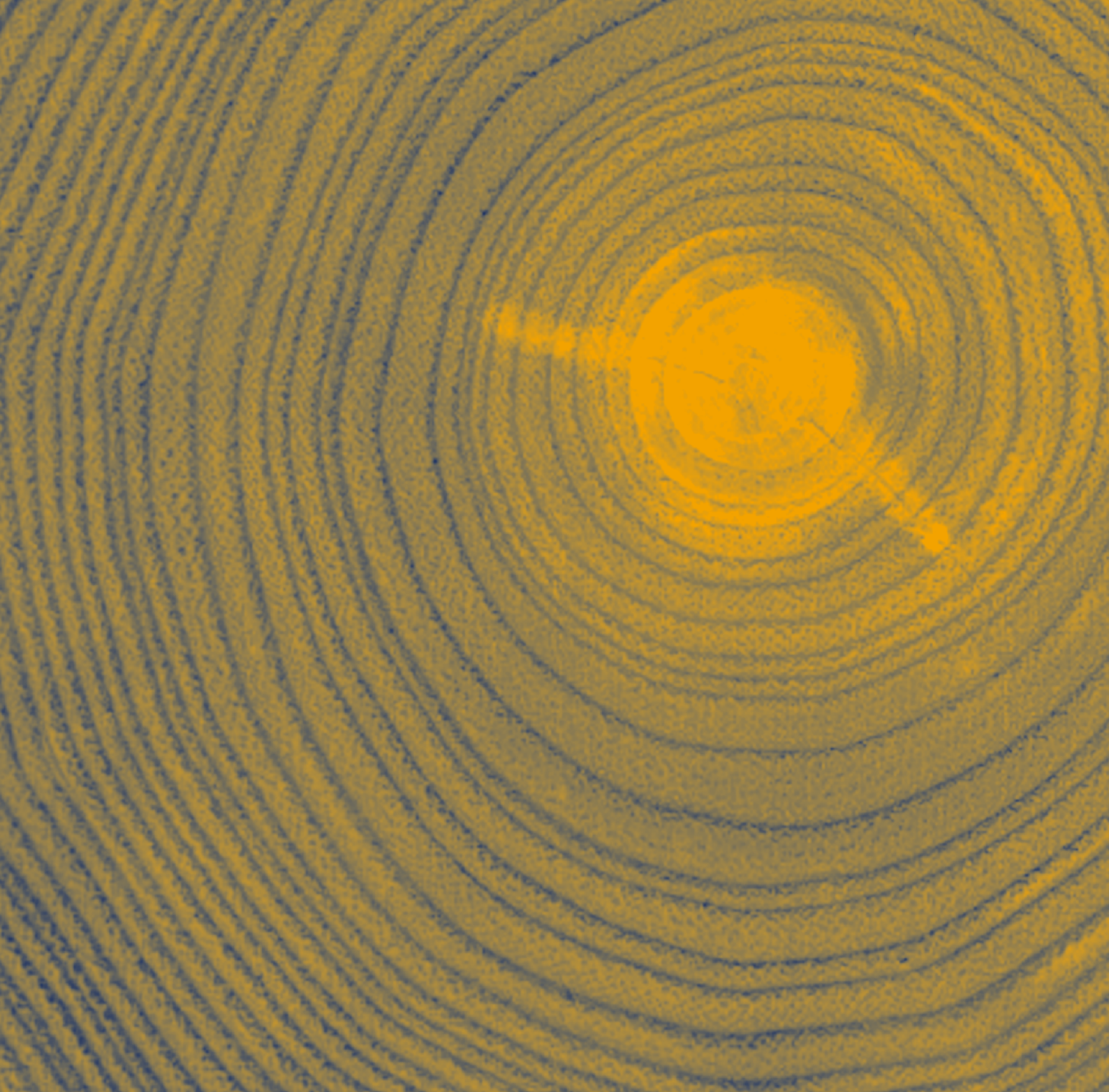
Taxation provision

- 7.43 The representative of the Minister for Finance confirmed that the Department of Finance will consider the various suggestions put forward in regard to tax-related matters in the Report. It will examine them in the light of their economic and budgetary implications, the findings of the examination currently in progress on pension-related tax reliefs and the needs of other areas of the economy.

Pensions awareness

- 7.44 The Board has been running the National Pensions Awareness campaigns since 2003. Regular surveys conducted by the Board since 2003 have shown a considerable increase in the level of pensions awareness.

The Board is of the view that further awareness campaigns should form an important part of any voluntary pension system, with continued emphasis on the Board's priority groups of women and the lower paid.



CHAPTER 8

MANDATORY PENSION PROVISION

CHAPTER 8 – MANDATORY PENSION PROVISION

Introduction

- 8.1 The purpose of this chapter of the Report is to examine the advantages and disadvantages of mandatory supplementary pension systems. The views of the Board are set out in section 8.18 below.

This chapter considers mandatory supplementary pension systems in general and, as far as possible, seeks to avoid consideration of the details of any particular system. This approach has been adopted for two reasons:

- Design of any pension system is very complex. Even an outline of this work would not have been possible in the time available, and in any case would have been premature ahead of a policy decision
- Broadly speaking, most people are in favour of, or opposed to, mandatory supplementary pensions on principle, rather than because of the detailed provisions.

- 8.2 It is very often pointed out that Ireland already has a mandatory pension system in the form of the PRSI based OACP. The Board strongly supports the continuation of this system of provision.

- 8.3 Given the first pillar system that already exists, it is necessary to be very clear about what is meant by a mandatory pension. There has already been discussion in Chapter 3 about what is the appropriate level for the OACP. What is considered in this section is a mandatory pension system intended to provide a retirement income greater than that necessary to avoid poverty. There are a considerable number of possible systems, including:

- A significant increase to the first pillar pension. Alternative 5 in the LS/ESRI report is an example of this approach, and examined increasing the OACP to 50% of GAIE
- Mandatory contributions paid to a financial institution. The Australian pension system is the most familiar example of this approach
- A State pension scheme whereby additional statutory deductions are made from salary and at retirement, in addition to the basic OACP, a further pension is provided based on earnings, contributions or some combination of the two.

- 8.4 A mandatory supplementary system could include 100% of the workforce or some smaller proportion, and could be designed to provide NPPI target benefits or some smaller retirement benefit. If a decision was taken to implement a mandatory system, the following parameters would have to be defined:

- who would be included in the system – a system could apply only to employees or might include the self-employed; it could include the private sector or both private sector and public service, a system could be limited to earners above or below certain ages; there may be other eligibility rules, for instance exempting smaller employers
- the amount of mandated contribution – the rate at which this is set will depend on the benefit level being targeted: a mandatory system may not necessarily aim to provide a 50% replacement income
- how it would be introduced – whether it would cover all eligible individuals or merely new entrants to that category. If covering all eligible individuals integration with the current system would need to be considered

- the income from which the contribution would have to be paid – it is likely that income below a certain minimum would not be included, and that there would be an upper limit
 - division of the cost between eligible individuals, employers and the Exchequer. Exchequer costs would then have to be recovered from general taxation.
- 8.5. There is occasionally some confusion between the effects of a mandatory system and the effects of achieving the NPPI targets. Any consideration of mandatory supplementary pensions must clearly distinguish between the two. The NPPI target of 50% replacement income cannot be achieved without almost doubling the aggregate private sector retirement contributions currently being made. These increases will be needed whether the targets are to be achieved through mandatory or voluntary contributions, or some combination.
- 8.6. Sections 8.7 to 8.16 set out the main arguments that have been advanced for and against a mandatory supplementary pension system.

Personal responsibility and pension decisions

- 8.7. Many people believe that a retirement income of more than the first pillar pension is a personal choice and responsibility, and that it is not up to the State to make this decision on their behalf. In this view, people must accept the consequences of their actions, and it is not appropriate for the State to intervene, particularly given the potential costs and drawbacks of a mandatory pension system.

Underlying much of the support for mandatory pensions is the belief that many of those without supplementary provision are not making rational or informed decisions. Many others may have a vague awareness of the need for pensions but never quite get around to doing anything about it. There is a view that it is appropriate therefore to oblige them to make pension savings, and that they will not with hindsight consider these contributions wasted.

There is no doubt that ignorance of the value of the first pillar pension appears to be widespread. Furthermore, in general, anyone not directly involved with pensions tends to grossly underestimate his or her life expectancy in retirement and/or the cost of providing an income during that time.

Much of the difference in views on mandatory pensions arises from different views on how much public awareness and behaviour can be changed.

- 8.8. The view has also been expressed by some that employers have a responsibility to contribute to pensions for their employees, but that not all of them will unless they are obliged to do so. Employer organisations will not necessarily accept this view of their obligations.

Affordability

- 8.9. In surveys of pension attitudes, a proportion of respondents say that they are not making retirement provision because they cannot afford to do so. This is likely to be particularly true for those in their twenties and thirties with young families: the costs of housing and childcare for many leave them with little or nothing to put towards retirement. Mandatory pension contributions may cause difficulties for those who cannot afford to make supplementary provision, depending on the eligibility rules of the mandatory system.

There is a further group who believe that they cannot afford to contribute to a pension, but in reality could afford it at the cost of reducing their spending in certain non-essential areas. The effect of mandatory pensions on this group would impose a different priority on their spending, and the result will be that they will not be able to afford some things that they would otherwise have managed.

Cost

- 8.10 Many people have expressed considerable concern about the effect of mandatory pensions on employer costs, specifically the costs to employers who are not currently making pension contributions. They believe that any addition to employer costs will have an inevitable effect on international competitiveness, which is seen to be under increasing pressure, on inflation, and on employment. Especial concern has been raised about our competitiveness relative to our major trading partners, and the need to restrain relative costs. Mandatory pensions may not just impose direct employer costs: employee contributions may put pressure on labour costs; Exchequer contributions may result in additional taxation costs.

Where in a given industry, some employers are making pension contributions and others are not, or there is significant difference between the levels of contributions being made, the effect of mandatory contributions may be to equalise national competition to some extent.

The cost argument is to some extent the opposite of the argument about the potential reduction of existing pension benefits, which, if it occurs, will reduce the costs of many employers.

As mentioned in 8.5 above, if the NPPI targets are to be achieved this requires pension contributions to increase considerably. This can only be achieved (whether in a mandatory system or a voluntary system), without adding to employer costs, if the additional contributions are borne only by contributors, and/or by the Exchequer without recovering costs from employers. It is not axiomatic that a mandatory system must require employer contributions: however, most if not all such international systems do require employer contributions.

The cost may also impact on actual pay since many people consider pay and pensions to be one package. A mandatory employer contribution could result in a different split of the same overall remuneration cost and benefit.

If it is decided that a mandatory system would impose unacceptable employer costs, it would be useful to make clear whether this means that the additional contributions should be borne wholly by contributors (directly or via the Exchequer), or that the NPPI targets are too expensive and must therefore be reduced.

Restricting choice/third pillar

- 8.11 Mandatory pensions by their nature restrict the savings options available by obliging those affected to invest in specific pension vehicles (or to contribute to a State scheme). There are many who would prefer to have more control over their savings, or who would prefer to invest in ways that are unlikely to be included in any mandatory scheme, especially in residential property.

If people have chosen not to save, is it right for the State to oblige them to do so? There is an obvious precedent in the Social Welfare system, which requires contributions to be paid and provides basic benefits in case people's own resources are not enough. However, this system is intended to provide basic benefits only: a mandatory system is likely to provide more, and to oblige those at all income levels to save more.

Effect on current provision

- 8.12 Much opposition to mandatory supplementary pensions concerns the effect that such a system would have on existing supplementary provision.

If a mandatory system is introduced, it is quite likely, at least initially, to be at a level below that provided by many existing OPSs. This may be because of a lower prescribed contribution rate and/or a limited band of income to which the contribution applies. Although the mandatory contribution is by definition the prescribed minimum, there is considerable concern that it would also become the norm for many individuals and employers. This might occur for a number of reasons:

- Contributors and their employers may understand the mandatory contribution as being what is necessary for adequate retirement income rather than recognising it as a minimum

- Employers may see no competitive advantage in providing benefits above those mandated, particularly if employees are unaware of the value of pension benefits. In any case, employees may prefer extra pay rather than pension
- The integration of the mandatory systems with existing arrangements may be complex and eventually may have the effect of discouraging such arrangements. The greatest problems are likely to arise with defined benefit schemes, as integrating them with mandatory defined contribution systems is always complex, and the cost and trouble of complying with the regulation needed might become disproportionate.

When mandatory pensions were introduced in Australia, the number of arrangements which provided additional benefits fell considerably over a relatively short time. Whilst the introduction of mandatory pensions may have impacted on this it appears to have been influenced by a number of reasons including the considerable regulatory burden on defined benefit arrangements and the general shift in employers' attitudes towards the amount and volatility of defined benefit provision cost. However, many people oppose mandatory pensions because of the possibility of an adverse impact on existing pension arrangements in Ireland.

There is no straightforward means of ensuring that the introduction of a mandatory system would not have an impact on existing arrangements. Because almost all supplementary arrangements are voluntary, it would be unreasonable to prohibit any reduction in such provision, as this would impose a higher obligation on those employers who had voluntarily provided benefits. In order to minimise the effect on current provision, it would be important that the integration regulations be as simple and light as possible. However, all regulation has an impact and cost, and the effects could not be predicted for a complex issue like this.

On the other hand, employers would be deterred to some extent by terms of employment and industrial relations considerations from reducing benefits for existing employees. Competition for labour would be a further disincentive to any reduction. To some extent, it is not clear why employers who generally have no obligation whatsoever under current legislation to provide pensions would be less likely to provide them if they had a partial obligation.

Any mandatory system will increase coverage, and so improve the retirement of many people. It is a challenge to achieve a balance between this improvement and the benefits of those who already have coverage under the current system.

Whilst the current Irish pension system does not meet the agreed coverage and adequacy targets it provides a solid base and a key component of any mandatory system should be a safeguarding of this system. Lessons can be learnt from other countries' experience in this regard.

Guarantees

- 8.13 If those working are to be obliged to save part of their earnings for retirement, the return that they will receive must be considered carefully. In particular, many of those contributors will have little investment knowledge or experience and may be obliged to invest in funds about which they know little, and may incur losses as a result.

It has been suggested that if a mandatory system obliges investment with a financial institution, the State should consider providing an investment guarantee. There is no international precedent for this. However, the perceived need for such a guarantee is advanced by some as a further argument against a mandatory system.

Effectiveness

- 8.14 It is not easy to draw lessons from the experiences in other countries. Countries differ in their level of State provision, their employment practices, their social structures and their economic situation. Nonetheless, it seems to be true to say that no country has achieved the rate and level of pension provision envisaged in NPPI through truly voluntary means. Some countries, and in particular the Netherlands, have achieved very high levels of coverage and adequacy through industry arrangements which are in effect mandatory, but it should be noted that these involve a much higher level of employer participation and contribution than has been achieved in Ireland.

The NPPI targets require not just a high level of participation and contribution, but, perhaps more significantly, a considerable increase in participation and contribution levels over a relatively short time period. The Board is unaware of any country where this has been achieved by voluntary means.

Efficiency

- 8.15 The reason why mandatory pensions are ever considered is because they are the only way guaranteed to achieve national pension targets. Some members of the Board believe that no voluntary system, irrespective of what incentives and structures are instituted, will achieve the level of provision implicit in the NPPI targets. Furthermore, mandatory pension provision costs less than voluntary provision to achieve the same degree of pension. In general, voluntary provision must rely on public education, but more directly on a combination of sales and marketing and on tax and similar incentives. There is an inherent inefficiency in these costs, as they are incurred not just for the marginal cases, but also in those cases that would have made contributions in any event.

The sales and incentives costs are likely to be considerably less under a mandatory system, though it may be necessary to retain tax incentives and support for a mandatory system in order to make it acceptable.

The cost and efficiency argument is not the determining argument, but must be considered with the other advantages and drawbacks of voluntary or mandatory provision.

Timing

- 8.16 Two views have been advanced about the appropriateness of the timing of the decision to introduce a mandatory system.

The first view is that any major change to the pension system will take up to five years to put in place, and significantly longer before it begins to make a difference, particularly in terms of retirement income adequacy. Given the length of this lead-in, strategic decisions should be made now, rather than deferred.

The alternative view is Ireland is going through a period of unprecedented economic development and social change which is not sustainable in its present form. To develop a long-term strategy based on recent economic and social experiences would be very dangerous. It is therefore appropriate for the NPR to highlight the various options and their advantages and disadvantages, but they should be considered in a more stable economic, and thus social, environment when the impact of the fine tuning of the current strategy can be assessed.

Some members of the Board believe that a time limit should be put on the voluntary system. If enhancements are made to the current voluntary system, this should be in the context of a set timescale for a measurable difference to be observed.

Summary

- 8.17 In summary, any mandatory system can be structured to achieve any given set of coverage and adequacy targets. Achieving the NPPI coverage target, while not without difficulties is relatively straightforward. However, achieving the NPPI adequacy target can only be done at a significant cost and with serious economic implications. The specific mandatory systems that have been costed as part of the LS/ESRI

report clearly indicate the cost and economic implications of each system as well as the level of benefit that would be provided. It is important to remember that the cost of achieving the targets will broadly be the same whether this is achieved through voluntary or mandatory means. Thus if the cost of achieving the targets by mandatory means is deemed too high it follows that the targets are too high.

8.18 Some members of the Board believe that a mandatory approach is the only certain way of achieving the NPPI targets, and that such an approach should be considered urgently. However, others believe that the cost of this certainty is too great in terms of potential economic and other impacts.

8.19 The case made for any proposal for a mandatory private sector system would have to be assessed in the light of judgements on:

- the ability of the pensions industry to provide a fair, comprehensive, competitive and comprehensible service to a largely financially-unsophisticated public
- the implications for the tax relief system
- the effects on other forms of saving nationally
- the possibility of the element of compulsion involved generating claims of State liability to make good shortfalls in the event of losses suffered by members not only on the collapse of individual schemes but also in the normal year-to-year operations of the various schemes.

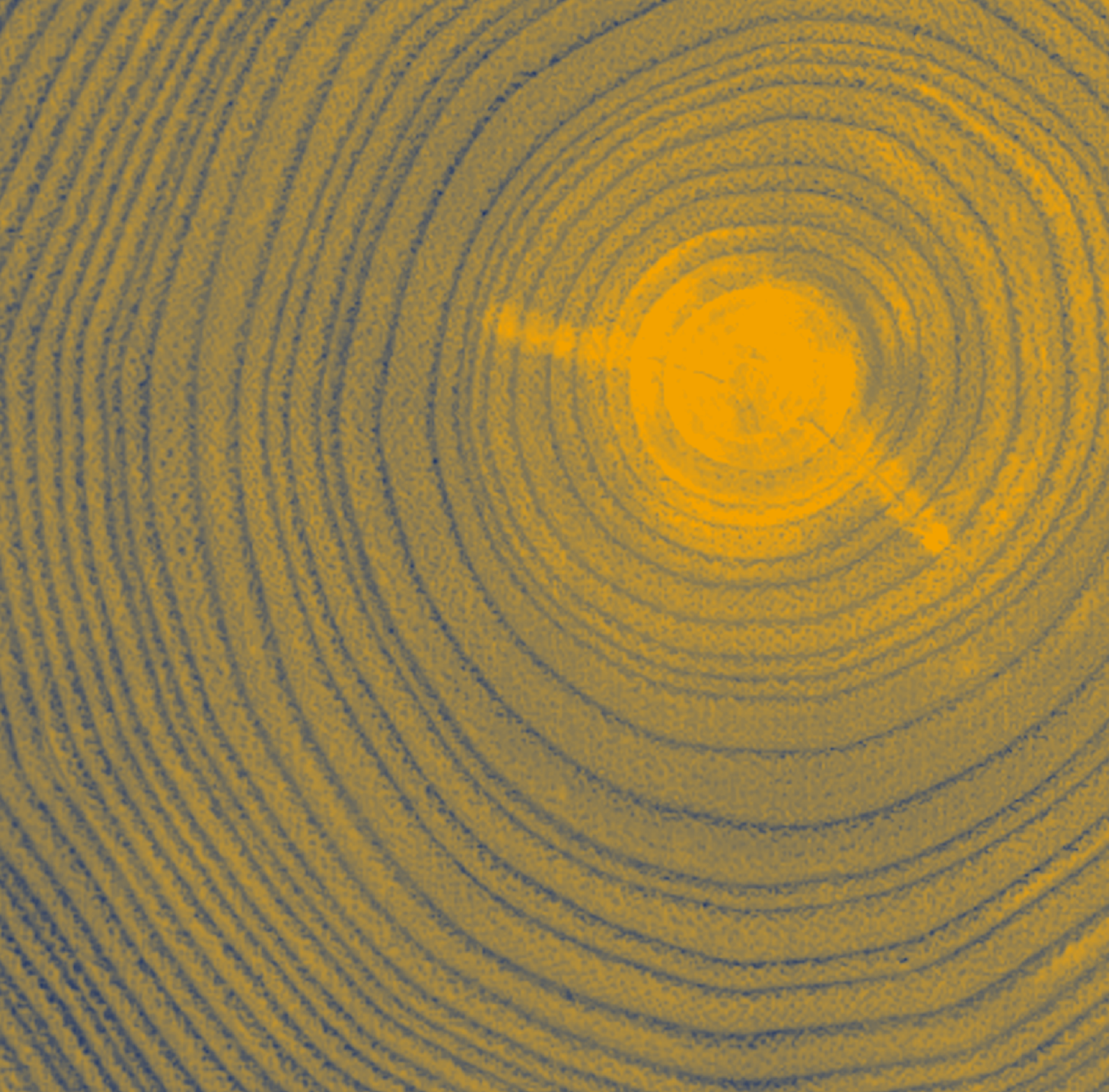
The case made for a mandatory State-run system would have to take account of:

- the cost of the system to the Exchequer
- the implications for the saving and financial services industry generally
- the degree of State liability entailed in compulsion to join a State-run pension system.

8.20 Were the decision taken in principle to introduce a mandatory supplementary system, the means of introducing it would also require considerable thought. It may well be thought impractical to introduce a full system immediately for economic or other reasons: there would be a number of potential alternative approaches, some of which are outlined as follows:

- A mandatory system could be introduced with a long lead-in time
- The amount of mandatory contribution could increase gradually to the target rate. This approach allows time for contributors to adjust to the cost of the system
- The income subject to mandatory contribution could be increased gradually over time. The potential drawback of this approach is that the impact of the system in the early years will differ significantly among people of different incomes
- The mandatory system could be limited to those entering the workforce or those born after a certain year. Such an approach would have to avoid creating disincentives to the employment of those subject to the mandatory scheme.

A possible alternative would be a form of quasi-mandatory system as discussed in 7.36 to 7.38 in relation to a system of automatic enrolment.



CHAPTER 9

STATE RETIREMENT SUPPORT

CHAPTER 9 – STATE RETIREMENT SUPPORT

Overview

- 9.1 A number of submissions advocate that in order to encourage supplementary provision the State should provide annuities in certain circumstances, or otherwise support private sector pension provision through price mechanisms. This subject was also discussed in the Board's 2004 review of the funding standard for defined benefit schemes. That report recommended that the issue be examined further.

Three specific proposals were examined as follows:

- Provision by the State of annuities for retired members of defined benefit schemes which have been wound up involuntarily
- Provision by the State of annuities to holders of small pension funds at retirement
- A State guarantee of investment returns on Standard PRSAs.

The first two proposals do not envisage a specific subsidy, though the State is undertaking a pricing risk; the remaining proposal will entail a State cost from time to time as the guarantee is invoked.

A report was commissioned on this topic from Hewitt Associates, and this is included in this report as Appendix 7. What follows is a very brief summary of the issues.

Annuities

- 9.2 At present, lifetime annuities are available only from insurance companies. These annuities must be bought in the following situations:

- By holders of PRSAs and RACs at retirement, who do not want to take their retirement funds in cash or to invest in ARFs
- By the trustees of defined contribution schemes when scheme members retire
- By the trustees of defined benefit schemes who do not wish to carry the post-retirement life expectancy risk in the scheme.

The cost of buying annuities has increased considerably in the last decade for two reasons:

- The price of annuities is linked to long-term bond rates, reflecting the asset investment policies followed by insurance companies in respect of their annuity assets (it should be pointed out that under life assurance regulations, if they followed any other investment policy, they would be required to hold additional reserves in respect of the additional risk). As bond rates have fallen in recent years, the price of annuities has increased
- Increased life expectancy means that insurance companies expect to pay annuities for longer, and this is reflected in the prices they charge.

The increase in the cost of annuities has had an immediate effect on individuals who are not members of defined benefit schemes on reaching retirement. In many cases, the amount of their pension has been less than expected, sometimes considerably so. The annuity cost also has an indirect effect on defined benefit schemes. The funding standard for those schemes is based on the market cost of buying annuities for retired members: as this cost has increased, so have the funding standard liabilities, resulting in many cases in increased contributions, and in some cases to problems in meeting the higher contribution rates.

- 9.3 It has therefore been proposed that the State should intervene as it is suggested that it could provide annuities more cheaply than insurance companies. The following proposals have been made; they are not mutually exclusive:
- The State should provide annuities to members of defined benefit schemes in the case of involuntary wind-up. Were these lower than the market cost, the funding standard, which is based on those costs, would be less onerous
 - The State should provide annuities to holders of small value pension funds, and/or to the first tranche up to that value for all individuals with pensions savings. The rates would be provided at a rate lower than available from commercial providers. It would be hoped that this provision would encourage more private pension provision.
- 9.4 The State could, it is suggested, provide cheaper annuities for the following reasons without incurring any costs or subsidies:
- The life expectancy assumptions would not be as expensive as those made by commercial insurers
 - The future investment returns that the State could anticipate could be higher than the bond returns assumed by insurers
 - A lower allowance for administration costs would be needed, and there would be no need for profit margins
 - Commercial insurers are obliged to hold additional capital, known as solvency margins, to provide security for policyholders, and this results in additional costs: these margins would not be needed by the State.

It is also argued that although the State would be incurring extra risk, and it is implicit in this proposal that the State would not charge for this risk, the quantum of the mortality risk is small in proportion to the life expectancy risk that the State bears for existing first pillar and public service pensions for almost 500,000 people. The investment risk is less quantifiable, but is still small in the context of the State's financial commitments.

There is not actuarial consensus that the assumptions underlying State annuity provision could be significantly lower. Furthermore, the representative of the Minister for Finance considers that:

- there is considerable disagreement about whether the State's life expectancy assumptions would be any less cautious and therefore any lower than the market generally
- in order to assume higher investment returns than insurance companies, the State would have to either invest in a higher risk portfolio, or provide the returns on a PAYG basis
- the administration costs, including the acquisition of pensions-related expertise, would not be as insignificant as proponents of the proposal might suggest
- it could not be assumed that the fund could be confined to members of defined benefit schemes connected with wound-up companies, especially if members involved were found to be in a more favourable position than members of other defined benefit schemes, not to mention members of defined contribution schemes and PRSA holders. Demands for parity of protection from the State from the vagaries of the pension marketplace would be inevitable and, on grounds of equity, would be difficult to resist, at potentially very substantial cost to the Exchequer

- it is far from clear whether or not the State would be allowed under EU law to provide annuities in competition with the market, especially without providing the solvency margins that commercial insurers provide
- if the State was allowed by the EU to become involved in the annuity business, that action could well be mirrored by a corresponding disengagement on the private sector's part over time, on the basis that the State would play an ever-increasing role in the area – this would have substantial consequences for the State and the pensions industry generally.

9.5 A second proposal is that holders of relatively small PRSAs and similar funds could use their funds to enhance their first pillar pension rather than purchase an annuity from a commercial provider.

This proposal could be implemented on a basis intended to be cost neutral, or could include an explicit subsidy. Even on a cost neutral basis, it is likely to provide good value in comparison to commercial annuities:

- No provider currently offers an annuity linked to inflation or to first pillar benefit increases. The State annuity would therefore provide certainty of real income unavailable elsewhere
- Annuities for small annual amounts can be difficult to purchase and are likely to be relatively poor value for money because of administration charges. On the other hand, the marginal cost to the State of administering the additional benefit is effectively zero.

If these annuities are provided on a cost neutral basis, they might nonetheless appear to purchasers to be poor value for money, compared to the cost of a flat (non-increasing) commercial annuity. Even if the basis is financially attractive, the annual income may appear low relative to the lump sum cost of purchase.

The report prepared by Hewitt Associates Limited concluded that the introduction of State retirement support was unlikely to have any significant impact on increasing coverage or adequacy. However, many members of the Board believe that such support would have important direct and indirect impacts, and there is also interest in exploring this proposal further as a means of targeting specific groups.

In addition, there is no certainty that a concession by the State on the lines suggested could be limited to the provision involved and, as with the previous proposal, the legality under EU law of taking such an initiative would have to be considered.

Minimum return on pension investments

9.6 One specific suggestion for State support is that holders of small Standard PRSAs should have their benefits underwritten by the State so that they would be guaranteed a retirement income of, for example, €1 for each €15 of contributions made. It is proposed that the proceeds of the Standard PRSA would be paid to the State in return for which the contributor would receive an enhanced first pillar pension.

The purpose of this proposal is to remove the inherent uncertainty from defined contribution provision, and thereby make supplementary provision more attractive. It is recognised that this is likely to be of more interest to older contributors, who are more pension aware, and more likely to be aware of the risks of defined contribution volatility and the cost of annuities.

It is useful to distinguish the principle of this proposal from the practical details of the proposal, which may need to be considered further. The underlying principle is that the State should bear much of the investment risk for specific savings contracts: the important issue is whether or not the State should charge for this: the specific proposal was that it should not, and the guarantee is intended to function as an incentive to supplementary provision.

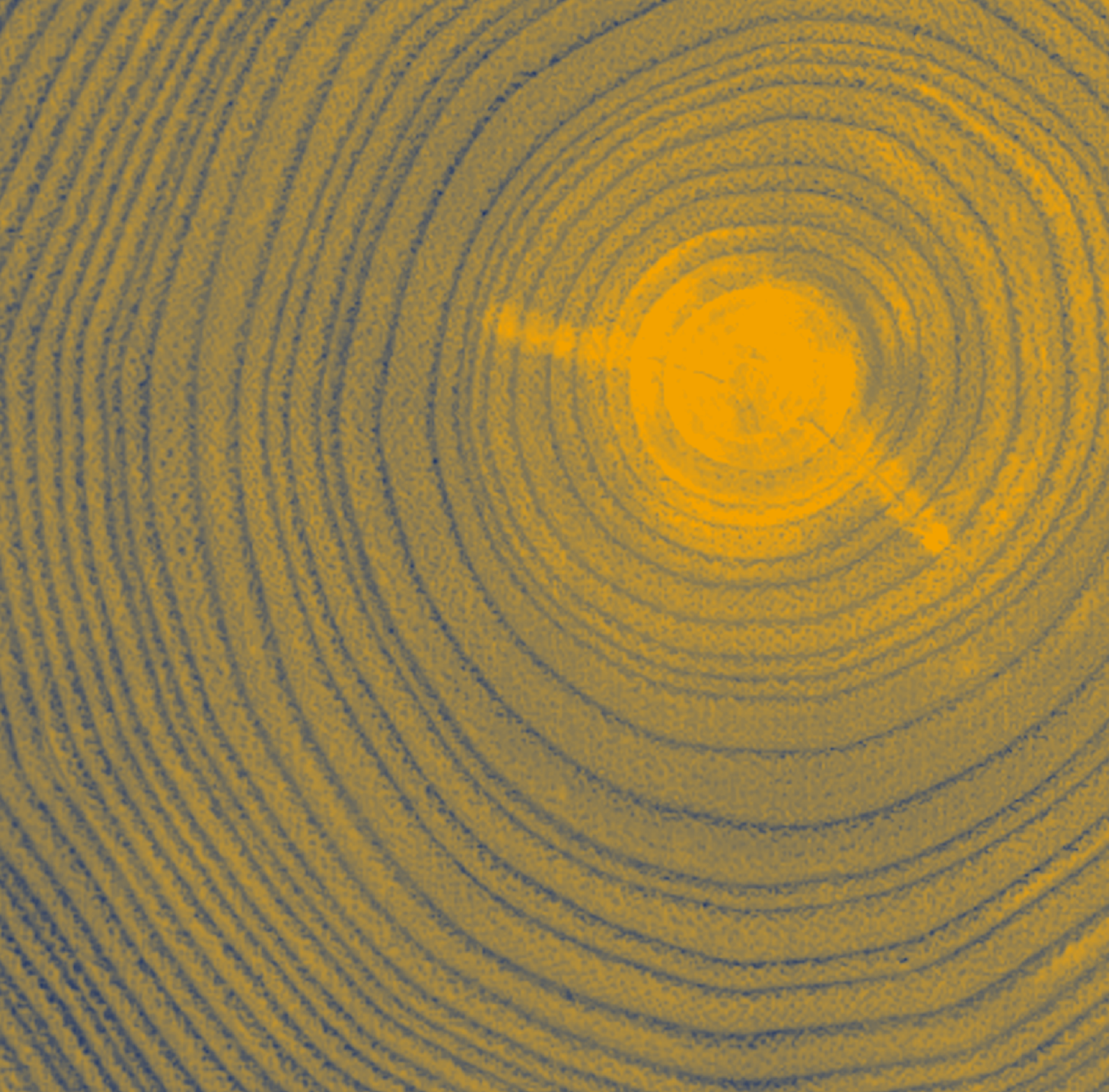
Among the practical details that would need to be decided would be whether or not the guarantee should be age related – a fixed ratio guarantee is of considerably more value and interest to someone near retirement than to someone in their 30s or 40s – and whether there should be a cap on the amount of pension fund that would be eligible. It should also be decided what investment choice should be available to those eligible for the guarantee.

An alternative means of achieving this aim is via a voluntary State savings contract rather than a guarantee overlaying a contract with a financial institution. Under the alternative, voluntary additional contributions would be paid to the State, who would provide extra first pillar benefits at retirement. From the Exchequer's point of view, this approach has the advantage of removing investment risk: if the guarantee is provided on a Standard PRSA, then the State is vulnerable to the investment strategy followed, and may need to impose restrictions. If it does not, there is an incentive for the saver to choose high risk investments in the knowledge that if they fail to perform, the State guarantee will be activated.

Even if there were no State guarantee involved, the State would be left to bear the very substantial life expectancy risk following the saver's exit from the labour force, while the savings provider would have had the benefit arising from selling the product to the saver in the first place and maintaining the investment account in the interval prior to the saver's retirement.

It is extremely difficult to estimate the cost of this proposal. Apart from the details of the guarantee to be provided, the cost depends on the performance of the Standard PRSA's investments: when investments perform poorly, the State would have a large number of claims from those retiring in that year: in other years, the cost could be zero. The economic cost would differ from the cashflow: where the guarantee is invoked, the State would receive the funds of those affected, in exchange for additional payments throughout their retirements.

- 9.7 Board members, apart from the representative of the Minister for Finance, believe that the proposal for State retirement support should be pursued vigorously, because of the potential benefits to supplementary pension provision.



CHAPTER 10

RELATED ISSUES

CHAPTER 10 – RELATED ISSUES

- 10.1 This chapter deals with a number of issues raised during the NPR which are relevant to the provision of pensions but have not been covered under the previous consideration of the current or alternative systems.

Defined benefit funding standard

- 10.2 A significant number of contributions to the NPR expressed continuing concern about defined benefit pension provision and in particular, the effect of the funding standard on the continuation of defined benefit schemes.

Since the original NPPI Report was published, the coverage target has received most attention and has been the focus of the primary efforts to achieve the NPPI targets. This approach reflects not only the fact that it is considerably easier to measure and report coverage, but also the view that it is more important to achieve some coverage for many people rather than adequate coverage for a smaller number of people. Nonetheless, it is important that the adequacy targets are not overlooked, and it would be of concern to the Board that people may consider that any second pillar provision is sufficient without being aware of the likely level of that provision.

The Board recognises the importance of defined benefit schemes within the current pension system to the achievement of the NPPI adequacy target. In the great majority of cases, at present only members of such schemes appear to have a reasonable chance of achieving the NPPI adequacy targets. It is therefore one of the priorities of the Board to facilitate the continuation of such schemes as far as possible, while ensuring an adequate level of protection for members of those schemes.

- 10.3 In 2003 and 2004, the Board undertook a comprehensive review of the funding standard. The recommendations that resulted are being implemented through the Social Welfare and Pensions Act 2005 and through changes in actuarial guidance. At the time of writing, these are just coming into effect. However, while incorporating considerably widened grounds for eligibility for extended funding proposals, it was not intended and was never expected that these changes would make a significant difference to the funding standard obligations of defined benefit schemes. The situation of those schemes has continued to be difficult because of further falls in interest rates and continuing increases in life expectancy.
- 10.4 Whilst it was not practical or appropriate for the NPR to revisit the review of the funding standard, the Board is aware of the concerns which have been expressed and will give consideration to whether it should recommend any further changes to the funding standard following completion of this Report.

Protection Fund for defined benefit scheme entitlements

- 10.5 A number of the submissions proposed that a protection fund be set up for defined benefit schemes which wind-up with a deficit.

As with the funding standard, it was not practical to include consideration of this as part of the NPR. However, in the 2004 funding standard review, the Board recognised the substantial potential benefits of a well designed pension protection system. The Board reiterates its intention to consider this issue further, taking account of practical and technical issues and of international experience.

Long-term care and pension provision

- 10.6 There is increasing awareness of the potential costs of long-term care for those unable to look after their own day to day needs. As this is an issue that usually affects people in retirement, it is appropriate to consider how to relate it to pension policy and provision.

A report on long-term care was prepared for the Department of Social and Family Affairs by Mercer Human Resource Consulting in 2003, and at that time the Board were invited to comment on the report insofar as it related to pensions. Among the points that the Board made were:

- It is the view of the Board that the financing of pension provision and long-term care provision are closely related, and have many similar considerations. It is important to assess the impact of any decision about long-term care financing on pension provision, and vice versa, in the context of policy aims regarding coverage and adequacy of overall pension provision as well as finite national resources
- The Board would have concerns about the potential effects of any means-testing of long-term care benefits. If the benefits concerned are of sufficient value, the testing may well act as a disincentive to the accumulation of pension savings
- Much long-term care is provided on an informal basis, and in the past, women within the family have usually filled this role. However, women have been one of the main targets of the National Pension Awareness Campaign, and increased pension coverage for women is one of the Board's priority objectives. There could be an adverse impact on achieving the pension coverage targets if there is continued reliance on women to provide informal care
- The Board does not believe that personal savings are likely to be a significant component of financing long-term care. It is difficult to persuade many to save for retirement, despite the tax incentives available, and despite the fact that savers would be much more aware of the need for retirement saving than for long-term care provision. Furthermore, it is unlikely to be efficient to save separately for retirement and long-term care rather than to save for retirement needs generally
- Equity release offers the opportunity to many older people to improve their retirement income and/or their long-term care provision without losing possession of their home. The Board would therefore welcome the further development of a properly regulated market, with appropriate safeguards, especially for those who may be financially inexperienced or otherwise vulnerable. However, given the many varied circumstances of those in retirement, equity release will not by itself provide a solution for retirement or long-term care funding

The Board is aware that a working group, chaired by the Department of the Taoiseach and comprising representatives of the Departments of Social and Family Affairs, Health and Children, and Finance, is currently examining issues in relation to long-term care, taking account of the Mercer and other reports, and the consultation process.

GLOSSARY

Additional Voluntary Contributions	Extra contributions which occupational pension scheme members can make in order to increase their retirement benefits
Annuity	A series of regular payments payable throughout the lifetime of the payee. It is normally secured by the payment of a lump sum to an insurance company
Adequacy	A measure of how much pension will be provided at retirement compared to income before retirement. This includes both first and second pillar pensions
Approved Retirement Fund	A fund in which certain retirement funds can be invested rather than purchasing annuities
Coverage	A measure of the proportion of the workforce that have supplementary pensions
Defined Benefit	An occupational pension scheme where the benefit payable is determined by reference to earnings and length of service
Defined Contribution	An occupational pension scheme where the benefit payable is solely dependent on the value of the contributions that have been paid to the scheme and the investment return earned on those
First Pillar	Retirement pensions paid by the State under its social protection programme. In Ireland these are the Old Age (Contributory) Pension, Old Age (Non-Contributory) Pension and State Retirement Pension
Funding Standard	This is a standard that requires defined benefit schemes to have enough assets to secure, in a wind-up position, the pension rights that members have built up. Defined benefit schemes must certify regularly whether or not they satisfy the funding standard
Gross Average Industrial Earnings	A measure of average earnings in Ireland to which the NPPI targets are referenced. At the end of 2004, the amount was €29,160 p.a.
Gross National Product	The total value of goods and services produced in Ireland in a year, plus overseas investment income, less payments to foreign investors in Ireland
Indecon Report	A report prepared for the Pensions Board in March 2005 by Indecon International Economic Consultants titled "Review of Potential Options to Encourage Increased Pensions Coverage"
Integration	The system of designing scheme benefits to take into account all or part of the benefits payable by the State at retirement in order to produce a desired overall income replacement rate
Living Alone Allowance	The Living Alone Allowance is a weekly payment for people receiving certain payments from the Department of Social and Family Affairs, who are living alone
Mortality rates	The average rates at which people die. These are used, inter alia, by insurance companies to calculate the cost of annuities
National Pensions Policy Initiative	An initiative jointly sponsored by the Department of Social, Community and Family Affairs and the Pensions Board. It was launched in 1996 to facilitate national debate on how to achieve a fully developed national pension system and to formulate a strategy and make recommendations for actions needed to achieve the system
NPPI Report	The report published as a result of the National Pensions Policy Initiative in 1998, titled "Securing Retirement Income"

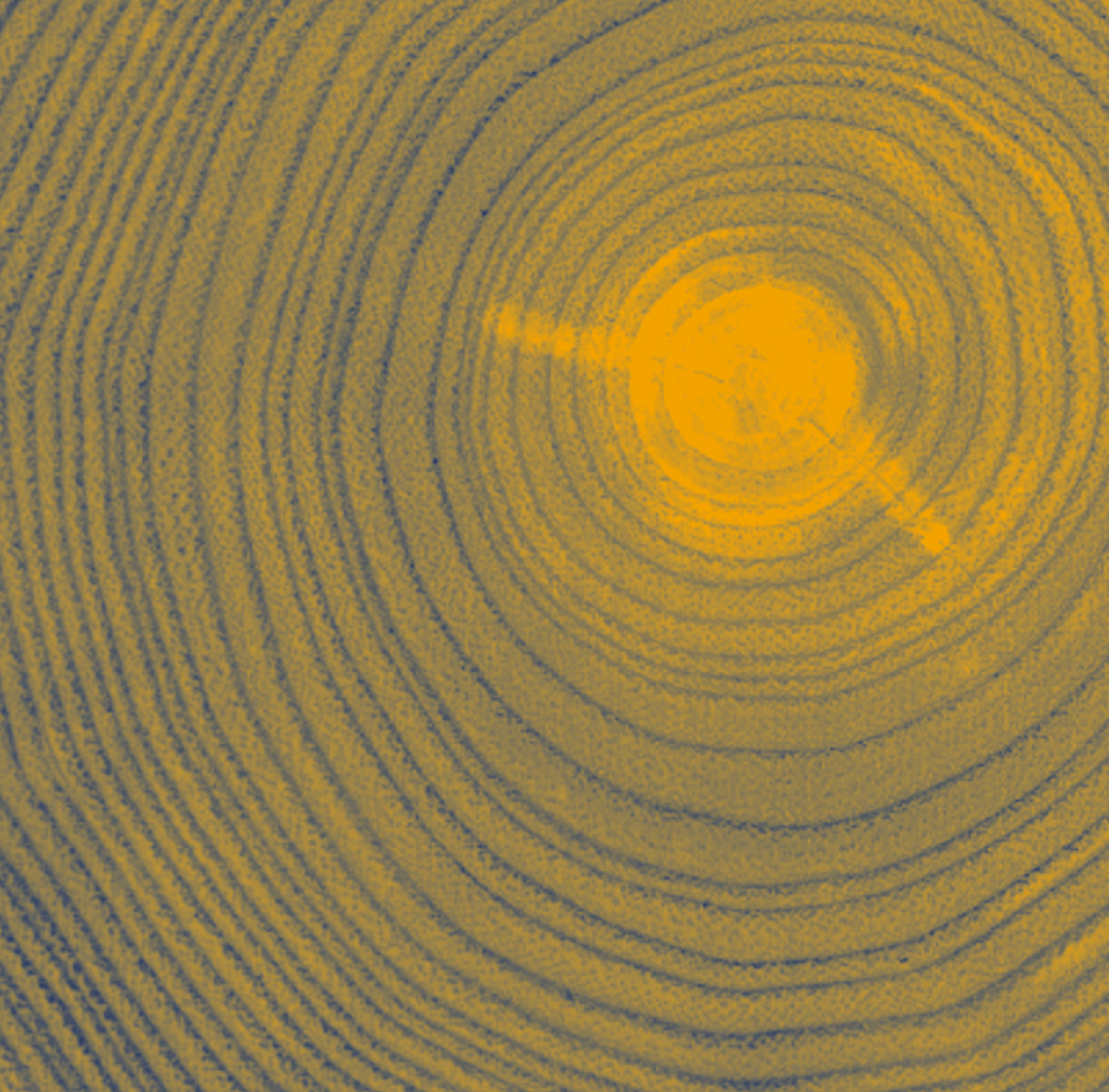
NPPI Targets	The National Pensions Policy Initiative devised specific targets relating to pensions coverage and adequacy
National Pensions Reserve Fund	A fund established by the State designed to pre-fund some of the projected increases in the cost of State and Public Service pensions
Occupational Pension Scheme	A pension scheme, established by and at least partly funded by an employer for the benefit of employees
Old Age (Contributory) Pension	A social insurance payment (part of the first pillar) made to people age 66 or over who satisfy certain conditions. Entitlement is based on PRSI contributions paid and the benefit is not means tested. The current maximum personal rate is €179.30 per week
Old Age (Non-Contributory) Pension	If an individual does not qualify for an Old Age Contributory Pension (OACP) or qualifies for an OACP at a reduced rate, they may opt to be means-tested for an Old Age (Non-Contributory) Pension. The current maximum personal rate is €166.00 per week
Pay-As-You-Go	The approach taken where benefits are not pre-funded but are provided out of current contributions. State pensions and Public Service benefits are provided on this basis
Pay Related Social Insurance	A Social Insurance contribution normally payable by employers and employees as a percentage of earnings
Pensions Act	The Pensions Act, 1990 (as amended). This is the main legislation governing occupational pension schemes and Personal Retirement Savings Accounts in Ireland
Personal Retirement Savings Account	An individual investment account used for retirement provision
Qualifying Adult Allowance	This is a means tested increase that may be paid on the first pillar pensions where a qualifying adult is living with the payee
Retirement Annuity Contract	A contract used for pension provision by self-employed and people in non-pensionable employment
Second Pillar	Pensions received in addition to first pillar pensions. In Ireland these may be occupational pension schemes, PRSAs or personal pensions. Also called supplementary provision
Special Savings Incentive Account	A savings account with a State incentive. Commenced on 1 May 2001, for every €4 saved to a special account the Exchequer contributed an additional €1 for a maximum of 5 years
Standard PRSA	A Personal Retirement Savings Account that must comply with certain investment requirements and capped charges. Employers must grant their employees access to such a product where no, or a restricted, occupational pension scheme exists
State Retirement Pension	This is a social insurance payment made to people reaching age 65 who satisfy certain conditions. The amount is based on PRSI contributions paid and the benefit is not means tested. A person must be retired from insurable employment to receive this pension. The current maximum personal rate is €179.30 per week
Supplementary pensions	Pensions received in addition to first pillar pensions. In Ireland these may be occupational pension schemes, PRSAs or personal pensions.
Third pillar	Provision for retirement arising from non-pension private saving or asset accumulation

ABBREVIATIONS

ARF	Approved Retirement Fund
Board	The Pensions Board
CSO	The Central Statistics Office
ESRI	Economic Social & Research Institute
EU-SILC	European Union Survey of Income and Living Conditions
GAIE	Gross Average Industrial Earnings
GNP	Gross National Product
LAA	Living Alone Allowance
LIIS	Living in Ireland Survey
LS/ESRI	Life Strategies Limited/Economic Social Research Institute
NPPI	National Pensions Policy Initiative
NPR	National Pensions Review
NPRF	National Pensions Reserve Fund
OACP	Old Age (Contributory) Pension
OANCP	Old Age (Non-Contributory) Pension
OECD	Organisation for Economic Co-operation & Development
OPS	Occupational Pension Scheme
PAYG	Pay-As-You-Go
PRSA	Personal Retirement Savings Account
PRSI	Pay Related Social Insurance
QAA	Qualified Adult Allowance
QNHS	CSO Quarterly National Household Survey
RAC	Retirement Annuity Contract
SSIA	Special Savings Incentive Account
SRP	State Retirement Pension

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APPENDIX 1

LETTER FROM MINISTER FOR
SOCIAL AND FAMILY AFFAIRS

3 FEBRUARY 2005

APPENDIX 1 – LETTER FROM MINISTER FOR SOCIAL AND FAMILY AFFAIRS

Office of the Minister for Social and Family Affairs

Mr Michael Mc Nulty,
Chairman,
Pensions Board,
Verschoyle House,
28/30 Lower Mount Street,
Dublin 2.

3 February 2005

Dear Michael,

As you know income for older people and pensions generally is a major priority for this Government. Since taking up Office I have focused on the current pensions strategy, the progress made, difficulties encountered and the issues which have arisen and which still have to be addressed. In this regard I am most appreciative of the hard work of Pension Board members in developing and monitoring the strategy and in seeking solutions for the difficulties which have arisen.

In the Social Welfare and Pensions Bill 2005, which I will publish shortly, I hope to build on the work of the Board in relation to the Funding Standard and the implementation of the IORPs Directive.

In relation to progress on the pension's strategy I think - you will agree that increased coverage and adequacy of this coverage is the most immediate priority. In this regard I have examined the progress made since the introduction of PRSAs and the commencement of the National Pensions Awareness Campaign and I regret to say that the coverage figures achieved are disappointing. Despite the hard work of all concerned it appears that we are failing to mobilise the general public and employers to start contributing to pensions in the numbers required to achieve our overall targets in any sort of reasonable timescale.

As you are aware, a statutory review of supplementary pensions coverage and related matters is due for completion by September 2006 and I understand that the Board is planning to start preliminary work on this review in the current year. However, I consider that the coverage situation is unlikely to improve dramatically over the next year and, in the circumstances, there is little point in delaying the review until 2006.

Accordingly and having discussed this at Government, I would appreciate it if the Board would undertake the full review of coverage and associated issues without delay.

In my view, this review should build on your existing work in relation to coverage and adequacy, and inter alia examine issues in relation to:

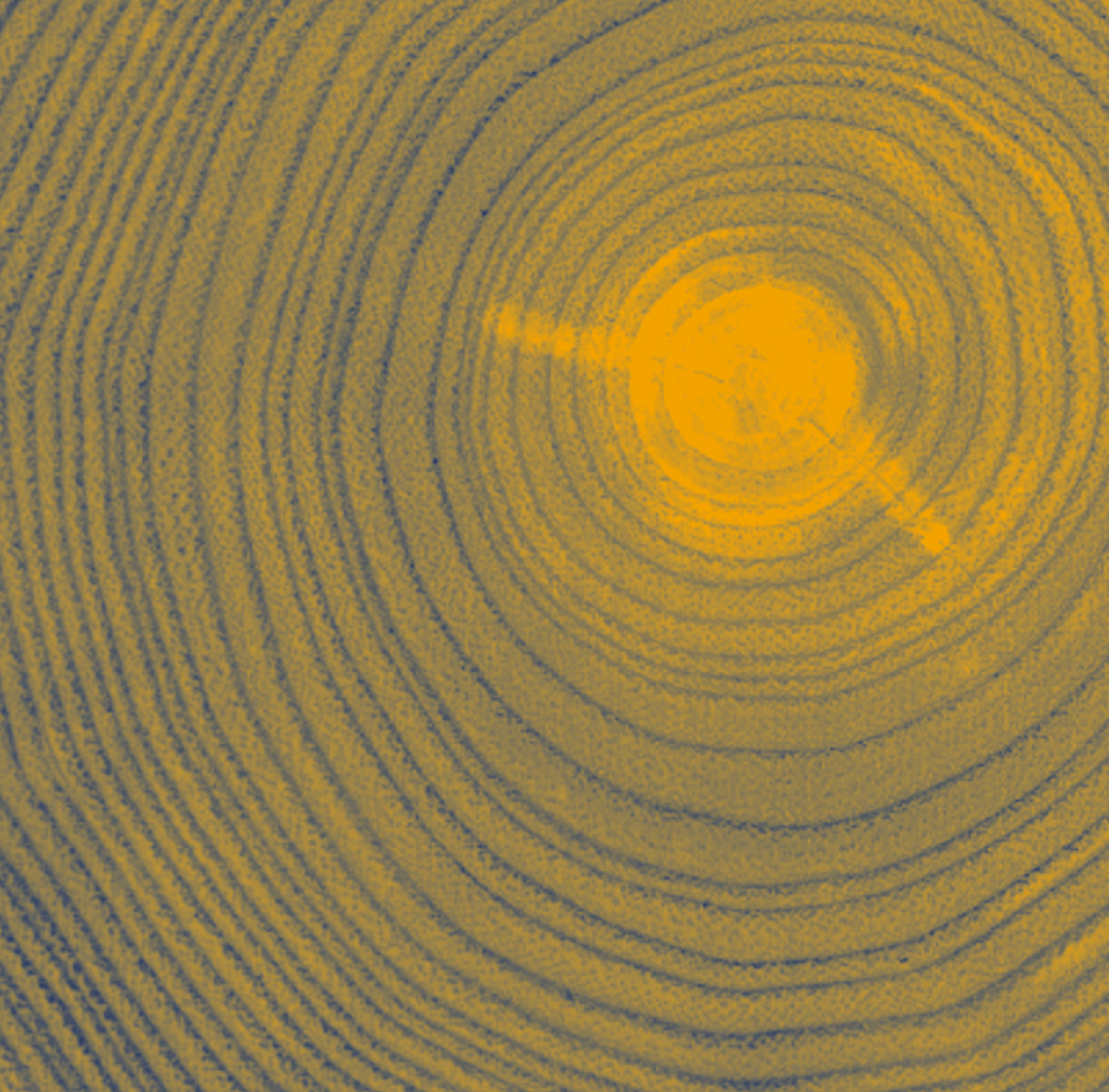
- Trusteeship, as set out in my recent letter.
- The State as a possible provider of annuities, on foot of the recommendation in your Review of the Funding Standard that this proposal should be considered thoroughly.
- The forthcoming Indecon report for the Board on coverage issues.
- Proposals by Jim Kehoe in his paper to the Society of Actuaries in Ireland last year.

No doubt the Board will have its own views on what should and should not be included in the review. However, I think we need to approach this exercise on the basis that our current strategy needs to be reviewed and that an alternative approach may be required. This can involve an examination of all the options that the Board consider worthwhile. Options should be discussed comprehensively, setting out the advantages and disadvantages, and the costs involved.

I appreciate the size of the task I am asking the Board to undertake. However I feel that we cannot allow the existing situation to continue and we must find a solution to our pensions problem urgently so that we can deliver on our commitment to ensure an adequate retirement income for all. I would ask the Board to complete its review and submit a report, with proposals to address the current situation, to me by mid June this year.

With best wishes,

Seamus Brennan T.D.,
Minister for Social Affairs.



APPENDIX 2

SCOPE AND MAIN COMPONENTS OF REVIEW

APPENDIX 2 – SCOPE AND MAIN COMPONENTS OF REVIEW

1. Review of National Pension Policy Initiative (NPPI)

To include:

- Review of NPPI's main strategic recommendations in relation to First and Second Pillar as an integrated national pensions system.
- Review of recommended adequacy level of gross retirement income from all sources (of 50% of gross pre-retirement income).
- Review of recommended level of Social Welfare pension (of 34% of average industrial earnings with certain indexation expectations).
- Taking a view on the sustainability of the combined costs of the First Pillar target level and Exchequer commitments on public service pensions.
- An examination of the relative merits of State support via continued net tax expenditure to the Second Pillar vis-à-vis cash expenditure of equivalent amounts under an enhanced First Pillar.

2. Review of coverage targets in NPPI Report (1998)

To include:

- Continued appropriateness (or otherwise) of targets (e.g. 70% of workforce aged 30 to 65 in 10+ years) in the context of changes in the social and pensions environment.
- Refinement of targets to derive a benchmark for the 2 years (to date) of the PRSA regime.
- Review of movement to date towards appropriate targets.

3. Review of current position under Second Pillar

To include:

- Current provision, structures, coverage, costs and adequacy including trends to date.
- Assessment of future outlook in the areas of coverage, costs and adequacy.
- Specific areas such as longevity, female coverage, retirement options (e.g. ARFs)/post-retirement provision, governance (insofar as it affects coverage and adequacy).

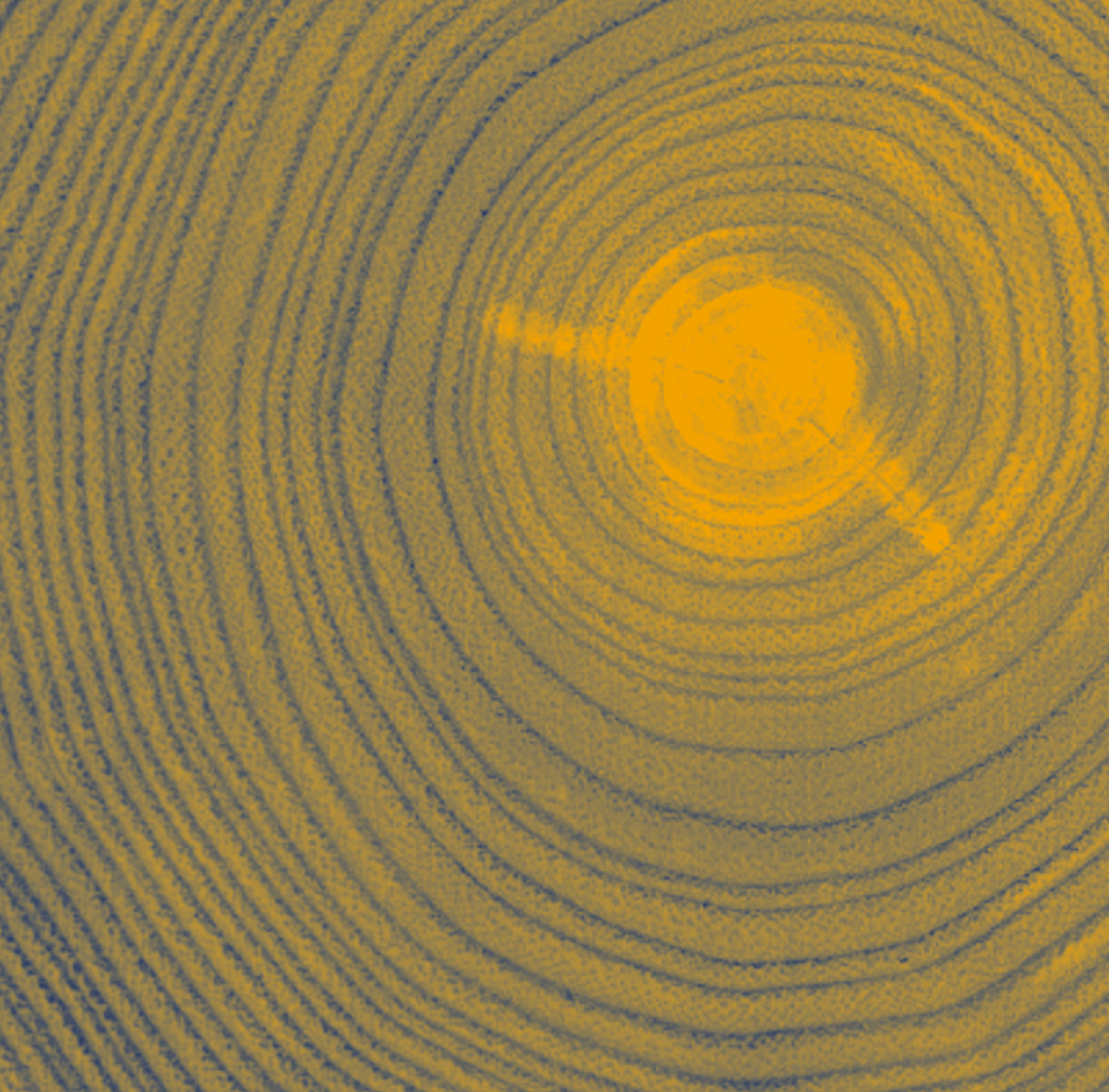
4. Options to address coverage and adequacy

To include consideration of:

- Possible further options to improve coverage within the present voluntary system (to encompass possible incentives for employers, employees and/or individuals including the INDECON Report's proposed recommendations).
- Both the three NPPI-identified mandatory options and other possible mandatory approaches (e.g. based on the PRSI system) to increasing coverage.
- Measures to improve adequacy (including required levels of mandatory contributions, possible State interventions such as annuity provision and underpinning of Second Pillar as in J. Kehoe proposals as well as possible increases in retirement age).

This consideration would include:

- Review of systems in selected other countries in the context of examination of the options.
- Assessment of costs and economic impact of those options (taking account of sustainability of First Pillar and public service pensions at 1. above).



APPENDIX 3

SUBMISSIONS RECEIVED

APPENDIX 3 – SUBMISSIONS RECEIVED

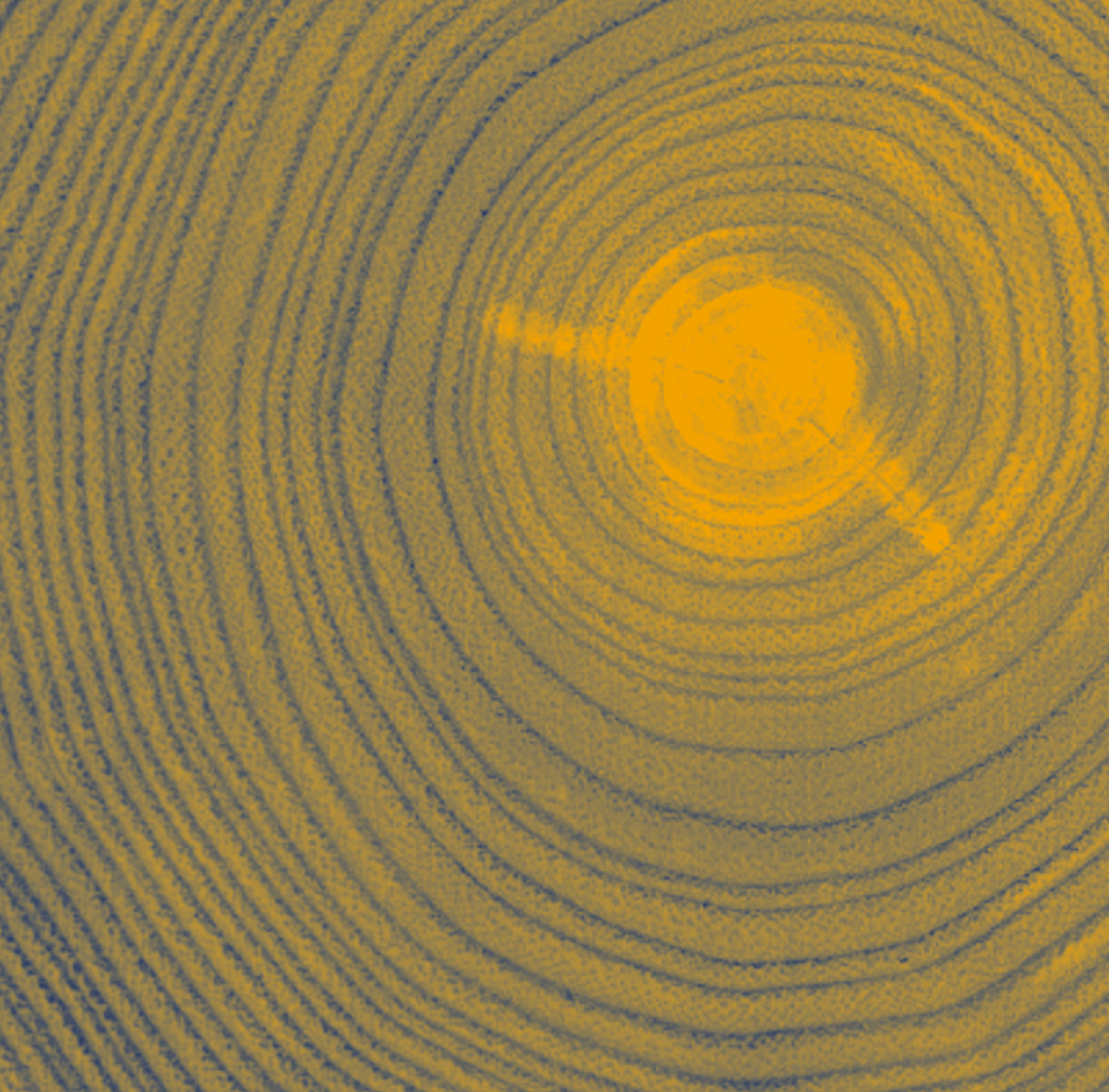
Submissions were received from the following individuals:

Mr. John Dowling
Mr. Damien Lee
Ms. Orla McCarthy
Mr. Tom McClafferty
Mr. Noel McGwynne
Ms. Geraldine McKenna
Ms. Anne McSweeney
Mr. David Moffitt
Mr. Francis Murtagh
Mr. Rodney Needham
Mr. John Power
Mr. Robert T.R. Woods

3 further submissions were also received from individuals

Submissions were received from the following organisations and professionals:

Bank of Ireland/New Ireland Assurance
City Life Limited
Combat Poverty Agency
Consumers Association of Ireland
Financial Outrage
GlaxoSmithKline
Irish Association of Investment Managers
Irish Association of Pension Funds
Irish Brokers Association
Irish Business and Employers Confederation
Irish Concrete Federation
Irish Congress of Trade Unions
Irish Institute of Pension Managers
Irish Insurance Federation
Irish Life Assurance plc
Irish Pro Share Association
Irish Senior Citizens Parliament
Irish Small and Medium Enterprise Association
Professional Insurance Brokers Association
Society of Actuaries in Ireland
Stephen Connelly & Company



APPENDIX 4

MERCER HR CONSULTING REPORT ON PENSION PROVISION IN OTHER COUNTRIES

MAY 2005

APPENDIX 4 – MERCER HR CONSULTING REPORT ON PENSION PROVISION IN OTHER COUNTRIES

Contents

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4	Second pillar pension provision	139
	■ Coverage by country	139
	■ Replacement ratio by country	139

1 Country Highlights

Section 2 provides detailed information on first and second pillar pension provision for the countries examined in this report. Items to note in relation to each country are as follows:

United Kingdom

The number of employees in DB plans has declined in recent years due to increased compliance and higher company contributions. Replacement ratios from DC plans are likely to fall unless both employer and employee contributions increase. This may lead to pension adequacy problems in future years.

Germany

The increasing cost of state pension provision has led the Government to establish a commission to look at means of reducing costs, including increases in the normal retirement age.

Italy

The state system is essentially a DC/career average plan with very few occupational pension schemes. The generous benefits provided are expected to lead to difficulties in funding benefits but the problem remains unresolved at the present time.

France

The generous nature of state benefits means occupational plans are uncommon, except for senior employees. There have been changes to the state system to reduce costs.

Netherlands

The majority of occupational plans are DB (over 80%) but the number of DC plans is increasing due to higher flexibility and the control available to employers over costs.

Sweden

There are two contractual pension plans in private industry – ITP and SAF-LO. Affiliation to these plans is compulsory for all members of the Confederation of Swedish Enterprise. Thus between social security and these mandatory plans, the majority of Swedish residents are covered for mandatory pension benefits.

Spain

Occupational plans tend to cover higher paid employees. Recent trends indicate that employees are starting to contribute to such plans to help share costs.

United States

The provision of occupational DB plans is becoming less common due to increased compliance and higher company contributions. There has also been an increase in the social security retirement age although IRS regulations mean that this cannot effectively be reflected in occupational plans.

Canada

As in other developed countries, increased compliance and additional contribution requirements mean DB occupational plans are being critically evaluated.

Chile

Chile was one of the first countries to introduce a social security system with individual DC accounts. Due to coverage and benefit levels, there are very few occupational pension schemes.

Japan

In order to control the cost of social security benefits, the Government has proposed an increase in the retirement age and a cut in pension payments of approximately 20%.

Australia

The minimum level of employer contribution to occupational plans has increased since first being introduced at 3%. Over time employers switched from DB to DC plans as a result of the minimum level, which became standard contribution rate to retirement benefits.

Singapore

To help control the cost of social security benefits, the Government's aim is to increase the retirement age from the present age 62 to age 67.

2 Detailed information by country

Country of Origin	Ireland	UK	Germany	Italy
1st Pillar Statutory Plans				
Type of Plan	Defined Benefit	Defined Benefit	Defined Benefit	Defined Contribution
Name of Plan	Social Security (Pay-Related Social Insurance - PRSI)	Social Security: Basic State Pension (BSP), State Second Pension (S2P) and Pension Credit	Social Security	Social Security
Plan Eligibility	Membership is compulsory for almost all persons aged between 16 and 66, irrespective of earnings.	All UK employees from the age of 16 who are paid more than the earnings threshold.	Most employees with the exception of self-employed persons for whom participation is optional	Most employees in the private sector are covered by the system.
NRA Males	65	65	65 (63 for disabled persons)	62
NRA Females	65	Currently age 60. A common State Pension Age of 65 will be fully implemented by 2020.	65 (63 for disabled persons)	62
Pensionable Earnings	Not applicable - benefits are flat rate.	Not applicable for BSP. For S2P, total weekly earnings between the Lower Earnings Limit (LEL - GBP 79 per week for 2004/05) and the Upper Earnings Limit (UEL - GBP 610 per week for 2004/05).	Earnings up to the Social Security Contribution Ceiling (SSCC). From January 1, 2004 this is EUR 61,800 (Western) or EUR 52,200 (Eastern).	Total gross remuneration. For young hires (i.e. first employment after December 31, 1995), there is an earnings ceiling equal to Euro 82,401 per annum.
Final Pensionable Earnings	Not applicable - benefits are flat rate.	Not applicable to BSP as flat rate - (S2P is based on career average earnings).	Not applicable.	Not applicable.
Pensionable Service	Not applicable - benefits paid are flat rate, subject to meeting contribution requirements.	Qualifying Years (i.e. all financial years in which National Insurance contributions of at least 52 times the Weekly Lower Earnings Limit are paid or credited).	All years of contributions.	Not applicable.
Normal Retirement Benefit	The maximum weekly rates are currently EUR 179.30 for a single person and EUR 298.80 for a married couple, if one person is a qualified dependant. If the pensioner is aged 80 or over, an additional EUR 6.40 is paid per week. Further payments are made if the dependant is over the age of 80.	There are two main state retirement benefits: - The Basic State Pension (BSP) is a flat rate benefit. The full BSP from April 2004 is GBP 79.60 per week for a single person or GBP 127.25 for a married couple. To receive a full BSP the employee must have accrued Qualifying Years for at least 90% of their working life. A reduced pension is paid to employees with lower Qualifying Years. - The State Second Pension (S2P) is an earnings-related benefit introduced in April 2002. Benefits are geared towards lower earners, with the pension for a full career being assessed as: - A flat rate pension of GBP 2,996.80 per annum - Plus 10% of earnings between GBP 11,600 and GBP 26,584 per annum - Plus 20% of earnings between GBP 26,584 and GBP 31,720 per annum At a later date the government intends that the system will accrue at a flat rate.	The state pension is calculated on a complex formula of individual career earnings, average pay, revaluation, and insurance periods. The full benefits amount to about 40% of final earnings up to the salary ceiling, but actual pensions vary considerably depending on the contributions made. The average monthly pension payment, based on 45 years of insured service and on an average income, amounts to EUR 1,138.95 in the western Bundesländer and to EUR 992.70 in the eastern Bundesländer.	Defined contribution. The pension is directly linked to the contributions paid during the employee's whole career. Each year's contributions are revalued for the period to retirement in line with changes in the GDP index. The accrued contributions are converted to pension using a statutory rate which varies by retirement age (from 57-65).
Early Retirement Benefit	None	None	Early retirement is possible from 62, depending on various factors such as gender and disability. If an employee claims early retirement benefits, the pension is reduced by 0.3% for each month of early retirement. This reduction can be avoided by paying additional contributions. Employees can go on part-time employment from the age of 55, this allows them to reduce their working hours by 50%, however the employer must top-up the pension insurance contributions as if the employee were earning 90% of their former gross wage.	Early retirement is possible from age 57 for both males and females with lower pension conversion factor.

Late Retirement Benefit	If employee remains in covered employment after age 65, then a contributory old age pension will be paid from age 66. There are no restrictions to continuing in employment when claiming this pension.				Where benefits are deferred beyond State Pension Age, they are increased by 7.5% simple per annum (it is proposed that this rate will increase to 10.4% from 2010).		Late retirement up to the age of 67 is possible, and the pension which is not drawn is increased by 0.5% for each month of deferment.		Late retirement may be possible up to age 65 with higher pension conversion factor.	
	All benefits provided are adjusted annually. The increases are expected to be broadly in line with pay increases.				All benefits provided are adjusted annually (typically, according to RPI).		All benefits provided are adjusted annually (typically, according to CPI)		The pension is revalued each year in line with cost of living.	
Disability Benefit	The maximum basic amount payable is EUR 154.30 per week. A supplement of EUR 110.10 is payable to persons with a qualified adult dependent under age 66 and EUR 138.50 if aged 66 or over. A further EUR 19.30 may be paid for each dependent child under the age of 18 (or 22 in full-time education). Pension is payable for as long as the individual is permanently incapable of work, however, payment will stop if the person is rewarded any other pension from the state.				An incapacity benefit is payable during sickness but ceases at pension age.		Disability pension is payable if the member has made more than 5 years of contributions. The full benefit is paid in the event of loss of 100% of earnings capacity; i.e. the person cannot work more than 3 hours per day. The benefit ranges from 25% to 35% of salary up to SSC. The benefit will be reduced by half in event of partial loss of earning capacity; i.e. the person can only work for 3 to 6 hours per day.		In order to be entitled to disability benefits, the employee must have a loss of at least two-thirds of working capacity. The individual must be aged between 18 and 65 and must have made at least five years of contributions, with at least three years in the five years prior to the disability claim. For loss of 2/3rds earning capacity - benefits amount to the accrued retirement pension. For total disability - benefits amount to the retirement pension based on actual contributions and projected service.	
	Maximum Monthly Rates for Death Benefits' Pensions for Widow/Widower Pension: Under the age of 66: EUR 177.60 Aged 66 and under the age of 80: EUR 183.70 Over the age of 80: EUR 182.70 Orphans who meet the qualifying conditions receive a monthly EUR 124.30 pension. The full surviving spouse's pension is reduced if PRSI contributions of deceased person or spouse are insufficient. Additional supplements are paid for children under the age of 18 (or 22 if in full-time education), and if pensioners live alone.				There are bereavement benefits available to both widows and widowers.		In the event of the death occurring during retirement, the spouse's pension is paid at the same level as the retirement pension of the deceased person for the first three months. After this period it is reduced to 55% of the retirement pension.		Pays spouses' pensions (to widows and dependent widowers) of 60% of the accrued or actual retirement pension and children's pensions of 70% per child.	
Employer Contributions	Class A employer contribution to retirement, survivor, disability, and unemployment benefits: 10.75% of employee's reckonable earnings (no salary ceiling). A lower rate of 8.5% is levied if employee's income falls below EUR 18,512. Inclusive of National Training Levy.				No National Insurance contributions on earnings below Lower Earnings Threshold (LET - GBP 91 per week for 2004/05), 12.8% of weekly earnings above LET. No upper limit.		9.65% of pensionable earnings.		Contributions vary depending upon the category of the employed person and the employment sector. Typically contributions are approximately 24% of salary for retirement benefits.	
	Most workers pay class A contributions and are covered for all social welfare benefits and pensions. Class A employee contribution to retirement, survivor, disability, and unemployment benefits: 4% of employee's reckonable earnings up to a ceiling of EUR 44,180. A weekly amount of EUR 127 is disregarded in calculating the 4% rate.				No National Insurance contributions on earnings below Lower Earnings Threshold (LET - GBP 91 per week for 2004/05), 11% of weekly earnings between LET and Upper Earnings Limit (UEL - GBP 610 per week for 2004/05) and 1% of earnings above UEL.		9.65% of pensionable earnings.		Contributions vary depending upon the category of the employed person and the employment sector. Typically contributions are approximately 9% up to €38,000 and 10% above this level.	
Financing	Pay-As-You-Go				Pay-As-You-Go		Pay-As-You-Go		Information not readily available.	
Estimated Gross Retirement Income as per cent of an Average Salary Benchmark	27%				35%		40%		50%-70% (DC scheme so not readily available)	
Coverage	Almost universal				Almost universal		Almost universal		Almost universal	

Country of Origin	France	Netherlands	Sweden	Spain
1st Pillar				
Statutory Plans				
Type of Plan	Defined Benefit	Defined Benefit	Defined Contribution	Defined Benefit
Name of Plan	Social Security	Social Security	National Pension system (New System)	Social Security
Plan Eligibility	All employees	All residents.	All gainfully employed persons in Sweden have compulsory coverage under Social Security. Contributions to system can start from the age of 16.	All Spanish residents aged 16 or over who are gainfully employed.
NRA Males	65	65	65	65
NRA Females	65	65	65	65
Pensionable Earnings	Earnings up to the Social Security ceiling. The ceiling is altered once or twice a year (January 1 and/or July 1). The annual ceiling as of January 1, 2004 is EUR 29,712 p.a.	Not applicable	All Earned Income and Compensation capped at SEK 317250	Covered Earnings are subject to a maximum and minimum based on category of occupation.
Final Pensionable Earnings	Average revalued earnings limited to Social Security ceiling over the best 25 years of employment preceding age 60 or retirement date, depending on the insured birth date. The reference period is gradually being extended to 25 years, increasing by one year for each of the next 4 years for individuals born after 1944.	Not applicable	Not applicable	Average of Covered Earnings the 15 years prior to retirement.
Pensionable Service	All years of contributions.	All years of residence.	Not applicable.	All years of contributions.
Normal Retirement Benefit	The full pension benefit is 50% of covered earnings. The benefit is paid as a life annuity. The retirement pension will be increased by 10% if the retiree has raised three or more children for at least nine years prior to the children's 16th birthday. The pension is further increased by 10% per annum for a dependent spouse over the age of 65 (or 60 if disabled) provided the spouse does not benefit from any social security personal retirement/disability pension. The minimum annual pension after a full career is EUR 6,511.05 in 2004, proportionately reduced for lower contribution periods.	Flat rate benefit. For a full pension to be paid, the individual must have been a resident for each year between the ages of 15 and 65. If this condition is not met, a reduced pension is paid. A husband and wife are each entitled to 50% of the State pension (AOW) for married couples. Married Couple Benefit amounts to EUR 15,896.16. The single person's annual gross pension is EUR 11,611.20. If one partner is younger than age 65, the elder partner receives a pension of 50% of the State pension (AOW) for married couples.	3 sources of pension are: Income-Related Pension, Premium Reserve Pension and Guarantee Pension. The bulk of the pension entitlements comes from the Income-Related Pension which is calculated based on the pension proceeds accumulated over the working lifetime divided by a factor which is based on life expectancy and expected income trends and is the same for men and women. The amount of Premium Pension will depend on the value of the individual's invested funds at the time when the pension is paid out. A small Guarantee Pension is available to those who have low or no lifetime income.	Percentage of the average earnings according to the following service factors: 50% for the first 15 years of contributions; 3% for each year between the 16th and 25th; 2% for each year from the 26th years. Applicable percentage cannot exceed 100%, except in the case of late retirement. The maximum annual pension is €29,205.40 and the minimum is €6,788.64 (married)/€5,764.64 (single) - increasing annually to bring in line with the minimum wage.
Early Retirement Benefit	From age 60. The benefit varies with age and service.	Not provided.	Pension can be drawn from age 61.	For those contributing to the Social Security System in 1967 early retirement is possible from age 60, if they fulfil certain requirements. The pension is reduced by multiplying the amount by the following factor: .60 at age 60, .68 at age 61, .76 at age 62, .84 at age 63, .92 at age 64. However, if an employee has at least 30 years contributions, and applies for early retirement when the contract was not terminated voluntarily by the employee, the pension is reduced by the following factors depending on the years of contribution: 7.5% for 31-34 years, 7% for 35-37 years, 6.5% for 38-39 years, 6% for more than 40 years.

Late Retirement Benefit	May be deferred beyond 65 with increases in benefits even if the full contribution career has been completed.	Not provided.	The longer an individual works the higher the pension will be.	The percentage of retirement pension will be increased by an additional 2% per every year of contributions after age 65 up to 110%. This additional percentage will only apply if the individual has, at the date when he is 65 years old, been contributing to Social Security for 35 years.
Pension Increases	All benefits provided are adjusted annually (typically, according to CPI)	Social Security Benefits are adjusted twice a year on January 1 and July 1 in line with increases in the minimum wage.	Pensions are indexed with a certain index decided for each year.	All benefits provided are adjusted annually (typically, according to CPI)
Disability Benefit	Paid to persons under the age 60 for partial and total disability. From age 60 the Social Security retirement pension replaces the Social Security disability pension.	Disability benefits are available for a five year period after which time the beneficiary must complete a new application.	At least three insured years are required to qualify for compensation. Income-related compensation amounts to 64% of an individual's qualifying income. Guaranteed compensation is payable to those without or with a low income-related sickness or activity compensation, either in full, or as a top-up to achieve the minimum guaranteed level.	Partial Permanent - Lump Sum based on degree of disability. Total Permanent - 55% of covered earnings which could be increased 20% if older than 55. Absolute Permanent - 100% of covered earnings. Great Disability - 150% of covered earnings.
Death after Retirement	Survivors pensions are payable to a spouse subject to means test. The pension is equal to 54% of the expected retirement pension. In addition, the pension is increased by 10% if the couple had raised three children at least. The minimum amount for surviving spouse's pension is EUR 2,935.60 for year 2004.	Since benefits are payable to all residents, death after retirement benefits do not exist.	A conversion pension is paid for ten months to men or women who have not reached age 65, if an individual has a child under the age of 18, pension is payable for another 12 months (extended conversion pension). The pension will be 55% of the calculated expected retirement benefits. Orphans under the age of 12 will receive 35% and orphans over the age of 12 will receive 30% for the remaining years up to the age of 18. The current provisions cover death benefits for both spouses and partners.	Information not readily available.
Employer Contributions	8.2% on annual earnings up to EUR 29,712 + 1.6% on annual earnings.	None.	11.5% of earnings up to SEK 317,250	23.6% (contributions are levied for all earnings up to the minimum legal wage for each category. This figure is an average rate only because the contribution will depend on the degree of risk of the employment).
Employee Contributions	6.55% on annual earnings up to EUR 29,712.	Contribution Rates and Limits: Retirement (AOW): 1790%, taxable yearly earnings up to (EUR) 30,357. Survivors (ANW): 1.25%, taxable yearly earnings up to (EUR) 30,357.	7% of earnings up to SEK 317,250	4.7% (contributions are levied for all earnings up to the minimum legal wage for each category. This figure is an average rate only because the contribution will depend on the degree of risk of the employment).
Financing	Pay-As-You-Go	Information not readily available.	Information not readily available.	Information not readily available.
Estimated Gross Retirement Income as per cent of an Average Salary Benchmark	65% for low earners to 35% for senior execs.	45%	Target of new system is 55%-60% of final salary up to limit	Complicated career earnings formula
Coverage	Universal	Universal	Universal	Universal

Country of Origin	US	Canada	Chile
1st Pillar			
Statutory Plans			
Type of Plan	Defined Benefit	Defined Benefit (2-tier system)	Defined Contribution (New System)
Name of Plan	Social Security	1) OAS 2) CPP	Social Security
Plan Eligibility	All working population with the exception of certain categories of government employees.	OAS - All residents CPP - Compulsory for all workers, they must have contributed for at least 20 years to receive the maximum pension (workers with less service receive a reduced amount).	Wage earners and salaried workers.
NRA Males	65 and 4/12 in 2004. Full retirement age (FRA) will gradually increase until it reaches 67 in 2027.	65	65
NRA Females	65 and 4/12 in 2004. The full retirement age (FRA) will gradually increase until it reaches 67 in 2027.	65	65
Pensionable Earnings	The maximum earnings taxed for each year. In 2004, the maximum amount is \$87,900.	OAS - Not applicable CPP - Annual earnings in excess of CAD 3,500 and up to CAD 40,500	Monthly earnings up to a ceiling of UF 60. The UF (Unidad de Fomento) is a monetary unit used in Chile for any business transaction. The value of UF 1 at 31/3/2004 was CLP 16,820.26
Final Pensionable Earnings	Average of highest 35 years of lifetime earnings. Actual earnings are adjusted or "indexed" to account for changes in average wages since the year the earnings were received. Persons with less than 35 years of earnings will have years of zero earnings (for years less than 35) averaged to bring the total number of years averaged to 35.	OAS - Not applicable CPP - Based on earnings from age 18 - 65	Not applicable.
Pensionable Service	Insured status is based on quarters of coverage. Up to four quarters can be earned each year. A minimum of forty quarters is required to be insured, but additional quarters will not increase the benefit amount, rather it is the final pensionable earnings that determine the benefit.	OAS: Residency CPP: Contributions after the age of 18	All years of contributions. Minimum of 20 years to receive max benefit.
Normal Retirement Benefit	The retirement pension is based on the employee's age and earnings history, and the date of retirement. Initial monthly retirement benefits payable to average wage earners with a steady work history are approximately USD 1,193 per month for those attaining the age of 65 and 4/12 in 2004 and, for the highly paid, USD 1,825 per month. Additional dependant's benefits may be paid to a husband or wife age of 62 or over. A divorced spouse may also be eligible for the benefits provided that the marriage lasted for at least 10 years. A spouse who is caring for a disabled child or a child under the age of 16, may be eligible for a benefit regardless of age. Unmarried children under the age of 18, or under the age of 19 if in full-time education, may also receive 50% benefits, as may dependent orphaned grandchildren. There is a maximum limit on the amount which can be paid to a family subject to one person's insurance record.	OAS: CAD 463.39 per month as of April 2004 CPP: 25% of the average monthly-adjusted pensionable earnings during the individual's contributory period to a maximum of CAD 814.17 per month	The benefit is based on accumulated capital in the individual retirement account. The "minimum pension" is CLP 75,211.30 for retirees under age 70 and 82,237.16 for retirees age 70 or older. The overall target is to provide a projected pension of 50% - 70% of monthly earnings up to the ceiling of UF 60 at normal retirement age. To qualify for a minimum pension, employees must have contributed for at least 20 years. If the amount in the accumulated fund at retirement exceeds the target of 70% ("minimum pension", the excess can be drawn down as lump-sum (taxable). If the amount in the fund is sufficient to reach the target of 70% at retirement the individual receives the balance required from the government. If an individual has not completed 20 years service at NRA of 65, the individual can apply for a welfare payment at a lower level.
Early Retirement Benefit	Can retire as early as the age of 62. However, benefits are reduced accordingly. Those persons taking early retirement at age 62 currently receive a permanently reduced pension equal to 78.33% of the benefits available in 2004. By 2027, this reduction at age 62 will have been adjusted to 70%, the adjustment taking place on a gradual basis between 2001 and 2027.	OAS: Not applicable CPP: Contributing members to the CPP can retire from age 60 with 0.5% decrease per month for each month the pension commencement date precedes age 65.	Early retirement is possible for employees who have accumulated a pension fund equal to at least 52% (increasing by 3% increments per year until reaching 70%) of average indexed taxable earnings during the last 10 years of employment. Once a worker has met the 70% benefit threshold he can stop contributions and begin withdrawing his money.
Late Retirement Benefit	Retirement may also be delayed beyond the full retirement age, and benefits will be increased for each month of delay up to the age of 70. In the case of delayed retirement, the pension is increased for each month that the employee delays retirement from the FRA up to the age of 70. The increase depends on the length of the delay and the year of the employee's birth.	OAS: Not applicable CPP: Contributing members to the CPP can retire from age 70 with 0.5% increase per month for each month the individual postpones commencement of pension past age 65.	There is no obligation for pension payments to commence on reaching normal retirement age, nor is there an obligation to stop working.

Pension Increases	All benefits provided are adjusted annually (typically, according to CPI)	All benefits provided are adjusted annually (typically, according to CPI)	Pensions increase annually in line with inflation.
Disability Benefit	The benefits payable are based on covered earnings averaged over the period since 1950 (or the age of 21 if later) up to the onset of disability, excluding up to five years with the lowest earnings. Additional benefits may also be paid to spouses and children, and these are generally calculated in the same way as for spouses and children of retired workers.	OAS: Not applicable. CPP provide a disability pension of CAD 382.14 per month plus 75% of his/her pension.	After a medical review has verified the disability, a benefit equal to 50-70% of base salary for total disability and 35-50% for partial disability. After three years, the disability is reviewed again, and if deemed to be permanent, a pension is paid for life. The government guarantees a "minimum pension".
Death after Retirement	A surviving spouse who is at the full retirement age (FRA) receives a pension equal to 100% of the deceased person's pension in course of payment. Survivors who have not reached FRA receive a permanently reduced pension equal to 71.5% of the deceased worker's pension at age 60, and 81% of the deceased worker's pension at age 62. The pension paid to a surviving spouse (under the FRA) who is caring for a dependent child is equal to 75% of the deceased worker's PIA. The pension may also be paid to a divorced spouse. A pension equal to 75% of the projected retirement pension is paid to eligible children.	OAS: Not applicable. CPP provides 37.5% of deceased's pension.	Survivor's pensions are paid to eligible members of the deceased person's family. The spouse's pension is 60% of the retirement pension or 50% if there are children, plus 15% for each child.
Employer Contributions	Employer contributes 6.2% of earnings towards retirement, survivors and disability insurance benefits. In 2004, the maximum annual earnings limit is USD 87,900.	OAS: Not applicable. CPP is 4.95% of Pensionable Earnings	No direct contributions to an employees fund. Employers contributions can be recategorised as an additional gross wage.
Employee Contributions	Employer contributes 6.2% of earnings towards retirement, survivors and disability insurance benefits. In 2004, the maximum annual earnings limit is USD 87,900.	OAS: Not applicable. CPP is 4.95% of Pensionable Earnings	By statute, employees are required to contribute 20% of monthly earnings up to a ceiling of UF 60. Of the 20% contribution made by the employee, 13% is allocated to old age, survivor's and disability pensions and 7% is allocated toward health insurance. Additional contributions to the AFP are permitted. Employee contributions for the provision of mandatory and voluntary retirement benefits are tax-deductible.
Financing	Pay-As-You-Go	Pay-As-You-Go	All pension benefits are provided through privately owned institutions managing employee contributions. The government is not directly involved with managing pension savings, but enforces a legal framework (including requirements on allowable investments, minimum rates of return, reserve levels) within which Pension Fund Administrators (AFP's) operate. Employees may choose their fund and transfer their account between funds. Funds are invested in 5 different areas: a) One-time long-term government bonds at market rates of interest; b) Temporary residual payroll tax; c) Privatisation of state-owned companies; d) A budget surplus deliberately created before the introduction of the new system; e) Increased tax revenues that resulted from the higher economic growth fuelled by the new system.
Estimated Gross Retirement Income as per cent of an Average Salary Benchmark	45%	32%	Target pension is 50% to 70% of final salary up to limit of UF 60.
Coverage	Almost Universal	Universal	55% of economically active population (low due to high unemployment and high self-employment)

Country of Origin	Japan	Australia	Singapore
1st Pillar Statutory Plans			
Type of Plan	Defined Benefit	Defined Benefit	Defined Contribution
Name of Plan	Social Security - National Pension (NP) and Employees' Pension Insurance (EPI)	Social Security	Social Security - Central Provident Fund (CPF)
Plan Eligibility	All Japanese nationals and all residents in Japan.	Basic benefits are provided to residents who qualify under a means test, i.e. low-income residents or those with special needs.	All Singapore citizens and permanent residents who are employees must be included in the CPF. Foreigners are exempt.
NRA Males	NP: 65 EPI: 60 (planned to be shifted to 65 from 2013)	65	62 (67 is Government's long-term objective)
NRA Females	NP: 65 EPI: 60 (planned to be shifted to 65 from 2013)	Depending on date of birth, NRA is between 60-65 but by 2014 all women will have NRA 65.	62 (67 is Government's long-term objective)
Pensionable Earnings	NP: Not applicable. EPI: Monthly standard remuneration plus standard bonus.	Pension is a flat rate unrelated to pre-retirement earnings or length of service (other than for meeting the period of residency requirements).	The covered earnings contain two components; the Ordinary Wage (OW) is typically the employee's base pay, while Additional Wages (AW) include bonuses, commissions, variable pay.
Final Pensionable Earnings	NP: Not applicable. EPI: Career average of Standard Monthly Remuneration and Standard Bonus (revalued by index).	Not applicable	Not applicable
Pensionable Service	NP: Not applicable. EPI: From the month of employment to the month of retirement.	Not applicable	Not applicable
Normal Retirement Benefit	Old age pension paid after age 65: The monthly benefits consist of two portions, old age pension from NP and EPI. - NP: JPY 66,417 (if 40 years contributions) - EPI: Final pensionable earnings x 1.8087% x number of insured months x price index adjustment	Social Security pays flat rate Age Pensions. The current maximum rate (January 2004) is AUD 11,772.80 per annum for a single pensioner and AUD 19,656 per annum for a couple.	On reaching the age of 55, members may withdraw the savings from their Ordinary and Special Accounts after putting aside a Minimum Sum, in their Retirement Account, which is established upon retirement. A similar minimum must also be retained in the Medisave Account. The withdrawal amount is equal to the accumulated contributions plus investment growth. The minimum sum with effect from July 2003 is SGD 80,000.
Early Retirement Benefit	Information not readily available.	Not Provided.	Benefits are available from age 55. The benefit is the account balance in excess of the minimum sum required.
Late Retirement Benefit	Information not readily available.	No increase is applied to the above amounts if payment starts later than the age of eligibility. However, a "deferred pension bonus" was introduced, with effect from July 1, 1998, for employees working past the pension qualifying age.	Not applicable
Pension Increases	All benefits provided are adjusted annually (typically, according to CPI)	All benefits provided are adjusted twice-annually (typically, according to CPI).	Not applicable
Disability Benefit	NP and EPI both provide disability benefits to insured participants.	Disability support pensions are generally payable at the same rate as the Age Pension and are means-tested.	Employment Act allows the employee to withdraw the balance of the CPF account in the event of total and permanent disability.
Death after Retirement	NP and EPI both provide benefits to widows and dependent orphans of insured participants.	Benefits predominantly provide short-term assistance to recently widowed persons and others in order to allow them to adjust to changed financial circumstances. Social Security widow pensions are being phased out. The Widow's Allowance is payable to women who become widowed, divorced or separated after the age of 50 and who have no recent work experience. The base annual pension rates from January 1, 2004 are AUD 10,010 for a single person with no children, AUD 10,826 for a single person with children, and AUD 10,977 for a single person aged 60 or over. Bereavement payments are short-term assistance. The amount is subject to eligibility under the income and assets tests. The maximum rate is AUD 12,069 per annum.	Not applicable.

Employer Contributions	NP: None. EPI: Same as employees. 6.79% of standard monthly remuneration and standard bonus. (as of January, 2004). Planned to increase in steps of 0.177% per year to reach 9.15% in 2017.	None. Benefits are financed through general tax revenue.	55 and below : 13.0% Above 55 - 60 : 6% Above 60 : 3.5%
Employee Contributions	NP: JPY 13,300 per month. Starting from April 2005 this amount will increase by JPY 280 per year to reach JPY 16,900 in 2017. Individuals may pay additional contributions of JPY 400 per month to buy additional benefits. EPI: 6.79% of standard monthly remuneration and standard bonus. (as of January, 2004). Planned to increase in steps of 0.177% per year to reach 9.15% in 2017.	None. Benefits are financed through general tax revenue.	55 and below : 20.0% Above 55 - 60 : 12.5% Above 60 - 65 : 7.5% Above 65 : 5.0%
Financing	The National Pension is financed through contributions from covered individuals and through government subsidies. The Employees' Pension Insurance is financed through employee and employer contributions. 59%	Pay-As-You-Go General Tax Revenues.	Information not readily available.
Estimated Gross Retirement Income as per cent of an Average Salary Benchmark Coverage	Universal	27% Universal (but not all employees would qualify for benefit)	DC scheme so not readily available Universal

Country of Origin	Ireland	UK
2nd Pillar		
Occupational Plans		
Type of Plan	Defined Benefit (historically) or Defined Contribution (trend to DC, most new plans are DC)	Defined Benefit/Defined Contribution. Trend to DC now entrenched. Virtually all new plans are DC.
Plan Eligibility	Most plans extend to all permanent employees. Eligibility is commonly at age 21 after 6 months service, though due to recent legislation, companies must ensure that all employees have access to a personal pension contract (PRSA) unless they are included in the company pension plan within 6 months.	Most plans extend to all employees. There may be eligibility conditions. Beyond certain eligibility limits, employers must allow entry to its plan to all employees. If no plan is available, access to Stakeholder must be facilitated by the employer. Stakeholder plans are the UK equivalent of PRSAs.
NRA Males	65 although, in practice, many employees actually retire before. Senior executives sometimes have a retirement age of 60.	65 although, in practice, many employees actually retire before. Senior executives sometimes have a retirement age of 60.
NRA Females	65 although, in practice, many employees actually retire before. Senior executives sometimes have a retirement age of 60.	65 although, in practice, many employees actually retire before. Senior executives sometimes have a retirement age of 60.
Pensionable Earnings	DB: Typically base salary less an offset equal to one and a half times the full single person's state pension. DC: Usually base salary only.	DB - Most companies with a final salary pension scheme define pensionable pay as base salary only, the rest include some elements of variable pay such as shift allowances, overtime etc. Some companies operate an "offset" to pensionable earnings to allow for State benefits. DC - Base salary for some 60% of companies, with 20% using gross salary. The remainder of companies fall somewhere in between.
Final Pensionable Earnings	DB: Typically pensionable earnings averaged over 3 years. DC: Not applicable.	DB - The most typical final pensionable pay definition is the highest pensionable pay over the last 3 years, although there is a slight trend towards career average schemes. DC - Not Applicable
Pensionable Service	DB: Years and months of service. DC: Not applicable.	DB: Years and months of service. DC: Not applicable.
Normal Retirement Benefit	DB: Typically 2/3rds of final pensionable earnings after 40 years of service, scaled down for shorter service. Partial commutation of pension at retirement permitted up to certain limits; the lump sum is paid tax free. DC: Accumulation of contributions with investment growth used to provide a tax free lump sum up to a specific limit set by the Revenue with the balance used to purchase an annuity.	DB - A typical defined benefit salaried staff plan is contracted out of the state plan S2P, and provides a pension of 2/3rds of final pensionable earnings salary after 40 years' service, i.e. an accrual rate of 1/60th of final pensionable earnings per year of service. Almost all plans allow part of the pension benefit to be exchanged for a tax-free lump sum of up to 1.5 times earnings depending on service. DC - An annuity is purchased from the accrued funds at Normal Retirement Date. Contracted-out benefits must be used to buy an annuity that increases in line with Limited Price Indexation (LPI, i.e. in line with the Retail Prices Index up to 5% per annum for pre April 2005 service and 2.5% for post April 2005 service). An employee has the option of taking a lump sum from their accrued fund as a tax-free lump sum. The limit on the lump sum is 25% of the non contracted-out fund for a Stakeholder/personal pension or up to 2.25 times the starting pension for an occupational pension scheme.
Early Retirement Benefit	Nearly all plans allow early retirement from age 50 although employer and/or Trustee consent is usually required. For DB schemes the benefit is usually actuarially reduced, with reduction factors ranging between 4% and 6% per annum. It is becoming less common for early retirement benefits to be awarded or enhanced as schemes have moved into deficit.	Nearly all plans allow early retirement although employer and/or Trustee consent is usually required and the benefit is usually actuarially reduced, with reduction factors ranging between 4% and 6% per annum. It is becoming less common for early retirement benefits to be enhanced as schemes have moved into deficit.
Late Retirement Benefit	DB - Most plans provide for late retirement with appropriate increase for late payment. DC - Schemes typically allow the employee to defer the purchase of an annuity and to continue to earn investment returns until actual retirement date.	Under current rules, early benefits cannot be paid while the employee remains in the same employment. DB - Late retirement is permitted up to age 75 and the benefits are actuarially increased to date of actual retirement. Trustee or employer consent is usually required. DC - An employee can defer the purchase of an annuity until age 75 and can continue to earn investment returns to this age.
Pension Increases	Pension increases are usually provided by DB schemes, either guaranteed or discretionary.	Benefits earned after 6 April 1997 must increase in line with the Retail Prices Index capped at 5% per annum for service earned to April 2005, reducing to 2.5% for service after April 2005.
Disability Benefit	DB - Most companies provide short-term sickness benefits, which replace the full income prior to disability (this often lasts for a maximum period of 26 weeks). The majority of companies also have a long-term disability plan which provides benefits if the disability continues after a period of 26 weeks. These benefits usually provide between 66.6% and 75% of pre-disability salary, less the state benefits. In very occasional circumstances, the employee may be retired under the terms of the occupational pension scheme - usually receiving benefits as if he/she had reached age 65. DC - Treatment of members on disability varies by scheme and often depends on whether disability insurance exists.	DB - Most schemes allow for enhanced disability early retirement benefits, which can be as generous as 100% of the earned and projected retirement pension, subject to employer or Trustee consent. DC - An income continuation plan is often used in conjunction with defined contribution pension plans.
Death after Retirement	DB - Most plans provide spouses' pensions, this is usually 50% of the retirement pension. Pensions in payment are often guaranteed for 5 years. This means that if the member dies within 5 years of retirement the remaining instalments of pension are commonly paid as a lump sum benefit. DC - Depends on whether the annuity purchased has a guarantee and/or spouse's benefits.	DB - A spouse's pension of 50% of the member's pension at date of death. However, any reduction to the pension as a result of taking a lump sum at retirement is generally ignored when calculating the spouse's pension. Pensions in payment are often guaranteed for 5 years. If the member dies within 5 years of retirement the remaining instalments of pension are commonly paid as a lump sum benefit. It is also common for plans to pay dependants' pensions in the absence of a spouse. Children's pensions are also common and are generally payable up to age 18 or 25 if the child remains in full-time education. DC - Depends on whether the annuity purchased has a guarantee and/or spouse's benefits.

Employee Contributions	DB - Between 2% and 6% of pensionable earnings (majority of private pension plans are contributory). The employer covers the cost of any separate disability/death cover plans. DC - Average of 4% of pensionable earnings.	DB - Typically 5% to 6% for a 1/60th scheme although there has been a noticeable upward trend recently as a result of the increased cost of benefit provision. DC - Employee contributions are generally fixed throughout the member's working life, and the distribution of contribution rates is as follows: Lower Quartile: 2.0% Median: 3.5% Upper Quartile: 5.0% The current limit on employee contributions to an occupational scheme is 15% of gross earnings per annum including AVCs. The limit on contributions (as a % of gross earnings) to a personal pension plan or Stakeholder are: Up to 35: 17.5% 36 - 45: 20.0% 46 - 50: 25.0% 51 - 55: 30.0% 56 - 60: 35.0% 61 or more: 40.0% These limits apply to combined employer and employee contributions. Members may make contributions of up to £3,600 regardless of gross earnings.
Employer Contributions	For DB plans, offering a typical 1/60th final salary benefit, the employer cost is usually in the range of 15% to 20%. Current employer contribution rates are higher as a result of past service funding deficits in pension plans. DC - Typically 6% of pensionable earnings. Some employers use a service or seniority related scale. In order to receive tax approval for a retirement plan, employers must make a reasonable contribution. PRSAs: Employers may contribute, but are not obliged to do so.	For DB plans, offering a typical 1/60th final salary benefit, the employer cost is typically in the range of 15% to 20%. Current employer contribution rates are higher as a result of past service funding deficits in pension plans. DC - For more recently established plans, there is a trend towards using an age-related contribution scale along with a tendency to match employee contributions. Some employers use a service or seniority related scale and, overall, employers appear to be moving away from flat-rate contribution scales. The distribution of contribution rates is as follows: Lower Quartile: 4.5% Median: 6.0% Upper Quartile: 7.5% Stakeholder - Employers may contribute to a Stakeholder
Financing	Pension benefits are funded through irrevocable trusts, which usually use either an insured or non-insured approach. Small companies may insure pension benefits with life insurance companies at retirement. DC plans may be via PRSA or a conventional trust.	Pension benefits are funded through irrevocable trusts. Financing arrangements will depend on the size of the plan assets. Most plans will have investment managers directing the assets. Small plans may be fully insured. DC plans are typically funded through a Trust fund or a personal pension / Stakeholder contract.
Estimated Gross Retirement Income as per cent of an Average Salary Benchmark	66% including social security	66% including social security
Coverage	51%	43% by occupational schemes and 16% by individual schemes
Taxation (Summary)	Employer Contributions – Tax-Deductible Accumulation of Pension Funds – Tax Exempt Pension Income – Taxable	Employer Contributions – Tax-Deductible Accumulation of Pension Funds – Tax Exempt Pension Income – Taxable
Taxation (Detailed)	Employees' contributions made into a private plan are tax-deductible. However there are age-related limits on private pension plans and an upper earnings cap of €254k. Pensions are generally taxable, however part of the retirement pension may be taken as a tax-free lump sum. Employers' contributions to approved pension plans are tax-deductible and are not treated as taxable income to the employee.	Employees' contributions made into a private plan are tax-deductible. However there are age-related limits on private pension plans and an upper earnings cap of £105.6k. Pensions are generally taxable, however part of the retirement pension may be taken as a tax-free lump sum. Employers' contributions to approved pension plans are tax-deductible and are not treated as taxable income to the employee.
Past Experience & Emerging Issues		- From April 2006, maximum pension rules will simplify to total pension from working life capped at £1.5 M value. The cap will increase by a scale thereafter. - Replacement of Minimum Funding Requirement with Statutory Funding Objective. For valuations after 23 September 2005, Trustees & Employer must draw up Statement of Funding Principles. - Pension Protection Fund: Operational from 6 April 2005 a levy of £15 per active/pensioner and £5 per deferred plus a per member administrative charge. Very few DB plans have started in recent years and many existing plans have either closed to new entrants or ceased benefit accruals. This is primarily due to increased compliance and higher contributions.

Country of Origin	Germany	Italy	France
2nd Pillar Occupational Plans Type of Plan	Defined Benefit	Defined Contribution	Defined Contribution (most plans) or Defined Benefit (some DB plans exist - less than 15%).
Plan Eligibility	All employees for companies who offer pension scheme.	Company plans are not widespread so there is little established practice on eligibility.	Top executives, and sometimes extended to all white collar "cadres," due to the shortfalls in the mandatory plans for highly-paid employees. Approximately 45% of companies provide such top-up plans. In order to be tax effective, an "objective category" of participants or eligible employees must be defined. In collective plans, for example, "cadres" or "non-cadres" would be used. (The category can also be defined according to the hierarchical coefficient under the applicable Collective Bargaining Agreement).
NRA Males	65. Normal retirement age usually coincides with the date at which a full social security retirement pension becomes payable.	No established practice.	65
NRA Females	65. Normal retirement age usually coincides with the date at which a full social security retirement pension becomes payable.	No established practice.	65
Pensionable Earnings	Base salary.	The annual gross salary considered for TFR (statutory severance indemnity) calculation	Typically, the pensionable earnings are defined in the same way as for state pension benefits.
Final Pensionable Earnings	No standard practice.	Not applicable.	DC: Not applicable
Pensionable Service	Service from date of hire.	Not applicable.	DB: Benefit is typically calculated based on the average career's salary. All years of company service when the employee fills out the eligibility conditions (e.g. numbers of years within the Company as a member of the employee category eligible to the benefits (ex: 'Cadre')).
Normal Retirement Benefit	DB: A common monthly benefit pension formula is between 0.2% and 0.4% of salary below Social Security contribution ceiling (SSCC) plus between 0.9% and 1.2% of salary above SSCC multiplied by the number of years of service. After a full career, pensions typically amount to 10% to 20% of final earnings up to the ceiling, and 40% to 60% above the ceiling. DC: Sum of deferred annuities purchased by the contributions. This can be paid as an annuity or a lump sum.	The retirement benefit is equal to: - a maximum of 50% of the assets as a lump sum and an annuity for the remaining assets OR - an annuity related to 100% of the assets	DC: The pension paid at retirement is dependent upon the accumulation of the contributions with fund earnings and economic/personal conditions at the date of retirement. DB: Generally 1.5% to 2% of final pay per year of service limited to 35 years, inclusive of State benefits.
Early Retirement Benefit	Typically employees eligible for social security early retirement will be allowed to retire early. The company pension benefit is then reduced by 0.3% to 0.6% for each month of early retirement.	An early retirement benefit is available with at least 15 years of contribution to the fund and an age not lower than 10 years of the social security normal retirement age.	Typically available from age 60.
Late Retirement Benefit	Commonly there are no late retirement provisions in German pension plans. This means, the pension would remain as calculated for normal retirement.	Not applicable.	Employee contributions are typically allowed after the normal retirement age.
Pension Increases	The standard statutory requirement is that the company reviews the level of pensions in payment every three years. The increase awarded must be subject to a minimum of the increase in cost-of-living and a maximum equal to the rise in net income of the company's active employees. If the company is experiencing financial difficulties, lower increases may be justified. However, this rule does not need to apply to any pension promises given after December 31, 1998. The employer can instead limit its liability by guaranteeing an increase of at least 1% per annum.	The annuity is typically indexed by the rate of return of the fund.	Vary from one insurer to another, depending on nature of insurance contract.

Disability Benefit	DB: The disability benefit under a defined benefit plan is the projected retirement benefit projected to either age 55 or to the normal retirement age. DC: The contributions are typically used to purchase disability coverage. Employers usually give the employees the flexibility to choose the amount of coverage. The most common benefit level ranges from 30% to 60% of salary.	In case the employee is unable to work, the accrued benefits (employer and employee contributions, TFR and interest) are paid.	Account balance, according to the insurance contract terms, in event of total and permanent disability.
Death after Retirement	The typical spouse's benefit is approximately 60% of the retirement pension.	Depends on form of pension chosen at retirement.	According to the insurance contract terms.
Employee Contributions	For private retirement benefits financed by book reserves the employer pays the full cost, as employee contributions to such internal reserves are not practical. This is also the case for support funds. Employees sometimes contribute to pension funds (pensionskasse and Riester) and often to direct insurance contracts.	Employees are expected to contribute at a small fixed percentage of salary in order to comply with pension fund legislation.	Typically, the total contributions are shared equally between the employer and the employee (typically 1.5% to 3% by each).
Employer Contributions	DB: 100% plan cost. DC: 1.5% to 3% of salary below SSCC and 4.5% to 9% above SSCC.	The employer contribution typically matches the employee contribution. In addition, a portion of the TFR (100% for the participants who have started to work as employees after April 1993) is paid to the fund.	Typically, total contributions are shared equally between the employer and the employee (typically 1.5% to 3% by each).
Financing	There are several financing vehicles available for supplemental pension plans. The most popular method is a book reserve. Other methods include Support Funds, Pension Funds (pensionskasse and Riester) and Direct Insurance.	External pension funds generally must be established with the exception of certain cases where book reserves are permitted.	Supplementary plans are typically insured with insurance policies. The assets are mostly invested in equities or fixed income instruments.
Estimated Gross Retirement Income as per cent of an Average Salary Benchmark	15%	Information not readily available.	Information not readily available.
Coverage	57% by occupational schemes and 13% by individual schemes	8% by occupational schemes and 2% by individual schemes	10% by occupational schemes and 8% by individual schemes
Taxation (Summary)	Varies by Funding Vehicle	Employer Contributions -- Tax-Deductible Accumulation of Pension Funds -- Taxable Pension Income -- Taxable	Employer Contributions -- Tax-Deductible Accumulation of Pension Funds -- Taxable Pension Income -- Taxable
Taxation (Detailed)	- Contributions to and accumulation within insurance arrangements are not tax deductible but pensions received are tax exempt. - Allocations to book reserves and contributions to reinsurance contracts are tax-deductible but pensions received are taxable	- Contributions are tax-deductible up to 12% of annual salary. - Tax on investment income annually payable by the pension fund is equal to 11%. - Benefits are taxable.	Limits on tax-deductibility of employer and employee contributions
Past Experience & Emerging Issues	- Taxation is gradually moving from a T-E to an E-T system - Recent introduction PRSA-style system had very low take-up mostly due to overcomplexity (for instance having to re-apply each year) and low contribution limits - More companies are funding their pension schemes (historically book reserves used) but the push toward funding is coming more from governance than tax-incentives which remain quite low - Cost of supporting Germany's state pension scheme is seen as unsupportable given ageing population and workers have been coaxed by the government in recent years to accept lower pensions and longer working lives - German Commission to examine pensions proposes that the pension revaluation formula be supplemented using a sustainability factor so that pensions are raised whenever employment levels rise and lowered whenever the number of benefit recipients grows faster than that of contributors - Earlier in 2004 Germany announced a freeze on the pensions of the elderly; in effect the first cut in pension benefits in post-war German history.	- About a decade ago statutory pensions switched to a notional DC system with accumulation linked to GDP growth and NRA increased from 57 to 60. These changes were made in order to reduce the cost of Italy's generous statutory benefits - Italy is now Europe's biggest spender on pensions and to make matters worse Italy has one of the lowest birth rates and one of the most rapidly ageing populations. The need for reform is accepted but little progress has been made	Due to growing financing problems of the country's pension system, France has increased the length of time contributions must be made in order to obtain full-rate pension. According to some evaluations, this would reduce the projected deficit by 50% in 2020.

Country of Origin	Netherlands	Sweden
2nd Pillar		
Occupational Plans		
Type of Plan	Defined Benefit or Defined Contribution – mostly DB	Defined Benefit/Defined Contribution
Plan Eligibility	All permanent employees.	ITP Plan: All permanent salaried employees at least 28 years old. SAF-LO Plan: All wage earners.
NRA Males	65. High tech sector: age 60 or 62 is popular. New legislation: From 1 January 2006, all retirement plans must have a target retirement age of 65 for employees under 55.	65
NRA Females	Same as for Males	65
Pensionable Earnings	Total fixed income less an offset. The total fixed income consists of 12 or 13 times base monthly salary plus holiday and/or other fixed allowances.	ITP plan: Base salary plus holiday compensation (monthly salary times 12.2) plus an average of the last 3 years of bonus/commissions, up to a ceiling of 30 Income Base Amounts (IBA), SEK 1,269,000 in 2004. SAF-LO Plan: Gross salary
Final Pensionable Earnings	DC: Not applicable DB: Some plans use final averaging and some use career averaging Years and months of service.	Same as regular pensionable earning.
Pensionable Service		ITP plan: Qualifying period for a full pension is 360 months. SAF-LO: Not applicable.
Normal Retirement Benefit	DB: Typically pension of 70% of final average salary after 40 years of service, including State benefits (AOW). Supplemental pension plans are integrated with social security. The typical benefit is 1.75% of pension base per year of service. With new plans from 1 January 2006, higher accrual percentages will be more common. Percentages are maximized by law, in combination with a minimum franchise, depending on benefit system (final pay or average pay). DC: Accumulated account balance plus interest. DB and DC: Benefit form is typically a monthly annuity. Under new legislation, retirees are required to receive various pension options at retirement. Lump sums are not permitted in the Netherlands.	ITP plan: Under the ITP plan, the retirement pension amounts to 10% of the final annual salary below 7.5 IBA, plus 65% of the final annual salary between 7.5 and 20 IBA, plus 32.5% of the final annual salary between 20 and 30 IBA. No pension is paid on salary in excess of 30 income base amounts. There is a supplementary DC component of the ITP plan, called ITPK, with a 2% contribution of pensionable salary. The accrued reserve may be used either to facilitate early retirement or to boost the main normal pension. SAF-LO Plan: The accumulated balance of the DC account.
Early Retirement Benefit	Many companies provide additional early retirement benefits by extra contribution payments (on a voluntary or company-paid basis). Early retirement age is typically 60-62, subject to fiscal limits and often company consent.	ITP plan: It is possible to take early retirement with a small reduction from the age of 62 using a special subsidy fund under the plan. For early retirement before age 62, actuarial reductions are applied. SAF-LO Plan: The accumulated balance of the DC account.
Late Retirement Benefit	In most pension plans, employees can choose to delay their date of retirement. In return they get a higher annual payment. The latest retirement age is 70, according to Dutch law.	ITP Plan and SAF-LO Plan: Normally, the pension policy expires at age 65. However, there are instances where employers pay part of the salary into a defined contribution plan if the employee is still working after age 65.
Pension Increases	No mandatory indexation of pensions in payment. An employer who grants increases to pensioners who have retired directly from the company must apply the same rate of increase to all pensions in payment and deferred pensions. DB: Benefits are usually indexed, generally restricted to the investment return above the 4% or 3% technical interest rate that already has been taken into account in the calculation of premiums. In most instances, this may depend on financial status of the fund or employer. DC: Employee can use the option at retirement date to buy benefits inclusive or exclusive of annual indexation. A waiver of premium in case of disability is common to be included in the pension scheme.	ITP plan: ITP pensions in the course of payment are adjusted in line with changes in inflation (Alecta index). SAF-LO Plan: The pensions are adjusted differently depending on interest in the selected fund.
Disability Benefit		ITP Plan: Upon long-term disability of at least 25%, the benefit is equal to 65% of earnings between 7.5 Price Base Amount (PBA) and 20 Income Base Amount (IBA), and 32.5% of earnings between 20 and 30 IBA. If/when the employee becomes entitled to long-term activity- or sickness benefit from Social Security, an additional 15% on salary up to 7.5 PBA is paid out. Reduced benefits are available on partial disability as well. SAF-LO (AGS Plan): If the worker becomes entitled to long-term activity- or sickness benefit from Social Security, he/she also gets 15% of salary up to 7.5 PBA from the AGS Plan.
Death after Retirement	Typically 60% to 70% of retirement pension.	ITP Plan: Under the ITP plan, a widow/widower pension is paid of 32.5% of pensionable earnings between 7.5 and 20 IBA (increased base amount) and 16.25% between 20 and 30 IBA. The spouse pension is reduced by 25% if there are children under the age of 20 receiving a separate pension. Orphan pensions are based on the spouse pension and range upward from 55% of the maximum pension (75% if both parents are deceased). SAF-LO Plan: Benefit level is at the workers' discretion.

Employee Contributions	DB and DC: Employee and employer typically share contributions in ratio of 1/3rd : 2/3rd, respectively. DB: Contribution percentage should be same for all employees regardless of sex, age or marital status. Some industries, such as banking and insurance, still have no employee contributions. Employee contributions generally range from 5%-10%. DC: Total maximum contributions are calculated according to an age-related table so that accrual uniformly covers the member's working lifetime. For an individual plan, employees typically contribute between 5% and 10% of Pension Base. Due to new legislation (equal treatment act), it will be difficult to maintain an age-related contribution for the employee. An alternative is a fixed percentage of the Pension Base.	ITP and SAF-LO plans: None
Employer Contributions	DB: Balance of plan cost. DC: Following is an illustration of a typical contribution table: Employee Age : Contribution (% of Pension Base) 25 - 29 : 9% 30 - 34 : 11% 35 - 39 : 14% 40 - 49 : 17% 50 - 61 : 25%	ITP Plan: The average ITP premium was 14.2% of pensionable salary in 2003, including the premium for the long-term disability. For companies with high average salaries, the figures are much higher. SAF-LO Plan: The contribution rate is currently 3.5% of pensionable salary, starting from the date the employees attain the age of 21 and is subject to review in the context of renegotiations of the national collective agreement.
Financing	The Pension and Savings Funds Act (PSA) requires that, once a pension commitment has been granted to employees, it must be funded in an industry-wide pension fund, a company pension fund or an insurance company. Pension insurance is usually in the form of group deferred annuity contracts.	ITP Plan: Insured. Carrier is Alecta, with exception that for the supplementary defined contribution component of the ITP plan (ITPK), plan members may place these contributions with carriers other than Alecta. SAF-LO Plan: Contributions are paid to an individual pension insurance contract; employees are asked to select an insurance company of their choice. For those who do not express a choice, AMF will remain the insurance company by default.
Estimated Gross Retirement Income as per cent of an Average Salary Benchmark	70% including social security	10%
Coverage	90% to 95%	90% to 95%
Taxation (Summary)	Employer Contributions – Tax-Deductible Accumulation of Pension Funds – Tax Exempt Pension Income – Taxable	Employer Contributions – Tax-Deductible Accumulation of Pension Funds – Taxable Pension Income – Taxable
Taxation (Detailed)	Details of Taxation not readily available.	– if a company does not offer a pension scheme then it must pay 32% salary tax toward social security but this is reduced to 24% if a company pension scheme is offered – an annual yield tax of approximately 1% of scheme assets (insured or in fund) is payable as an accumulation tax – benefits are taxed as income
Past Experience & Emerging Issues	– FTK: solvency test for schemes was previously done using a book value of liabilities but under FTK liabilities will be valued at market value (but without future salary increases or revaluation); Annual Minimum Contribution amount does take into consideration future salary increases and revaluation – Contributions toward early retirements (before age 65) have recently been stripped of their tax exempt status which has prompted many companies to stop offering early retirements. There is also a cost involved in performing the actuarial calculations necessary to split the contributions into normal and early retirement buckets – Recent legislation concerning the definition of disability has made it much more difficult for employees to have disability status which affects the disability costs of both state and occupational schemes	– A new national pension system was introduced in 1999 and will be fully implemented by 2020. The old system was pay-as-you-go whereas the new system is based on member contributions – New system will consist of 3 components: income-related pension, premium reserve pension, and guarantee pension – Pension can be drawn from age 61 with target benefits of 55-60% of earnings after 40 years (compared to 30 years under the old system)

Country of Origin	Spain	US	Canada
2nd Pillar Occupational Plans Type of Plan	Defined Benefit (historical plans) but trend to Defined Contribution (due to recent legislation changes)	Defined Benefit (majority of existing plans), Defined Contribution (most newer plans), or Hybrid.	Defined Benefit/Defined Contribution
Plan Eligibility	DB: Eligibility often contains a minimum age and service requirement, commonly 2 years. Discrimination is strongly opposed in the Qualified Pension Plan, but it is possible to cover a defined group of employees (i.e. managerial, executives). DC: All employees.	Employer-sponsored retirement plans cover a large proportion of the working population over the age of 21 with one year of service (the usual eligibility requirement). Larger employers will provide a DB plan or DC plan with employer contributions. However, for smaller companies access is often only to a 401(k) plan (DC) with no employer contributions, affording employees the opportunity of tax deferred savings.	Includes all full and part-time workers within a specified class, subject to a minimum service requirement
NRA Males	65, although 60 is adopted by some plans.	65	65
NRA Females	65, although 60 is adopted by some plans.	65	65
Pensionable Earnings	Base salary, but the trend is to also include variable components of compensation in the definition (i.e. bonus). Average of the last 3 years earnings	DB: Usually base salary, sometimes includes overtime and bonuses. DC: Base salary.	DB: Usually base salary, sometimes includes overtime and bonuses. DC: Base salary.
Final Pensionable Earnings	Total years of service, though some companies only consider the number of years from the date the member joins the plan to consider past service rights.	DB: Final average salary. DC: Not applicable.	Average of earnings from 3 to 5 years.
Pensionable Service	DB: The goal of a supplementary plan is to provide a total retirement income (inclusive of Social Security benefits) equal to 70-80% of final salary. Maximum pensions (inclusive of Social Security) are in the range of 60% to 80% of final salary after a full career with an employer. As these replacement ratios include social security benefits, the ratios are higher for lower paid employees because of the generous social security benefits at lower salary levels. DC: Lump sum or a retirement and spouse's pension purchased with the accumulated funds.	DB: Years of service. DC: Not applicable	Service while participating in the plan.
Normal Retirement Benefit	DB: Some plans allow from 60 years (particularly in the executive group) with deferred pension or deferred lump sum. DC: Enhanced early retirement terms are rarely offered in DC plans.	Together with Social Security, supplemental pension plans aim to replace between 60% and 80% of final average salary for a low-wage earner, and 45% to 60% for a high-wage earner. A supplemental non-qualified plan is usually in place to provide additional benefits to executives.	A typical pension target of 60% to 70% of final average earnings (exclusive of benefits from non-contributory statutory schemes). DB - Max pension of the lesser of 2% of highest average compensation and CAD 1,722 x number of years of Pensionable service. DC - No max pension but annual contribution limits exist.
Early Retirement Benefit	Not common practice.	Most plans permit early retirement with reduced benefits as early as the age of 55.	Typically within 10 years of Normal Retirement Age. In DB plans, the benefit is reduced by 3% per year prior to age 60.
Late Retirement Benefit	Not common practice as many employees take their pension in lump sum form.	DB: Participants retiring late usually receive actuarially increased benefits, or continued accrual of benefits.	Applicable with the consent of the company. No later than age 69.
Pension Increases	DB: Equal to the benefit the employee would have received if he or she has continued to work until normal retirement age, including the Social Security benefits. DC: Typically a lump sum equal to 1 or 2 years salary for permanent disability.	After commencement, benefits are not usually adjusted for increases in the cost of living. However, some plan sponsors will voluntarily increase benefits payments on an ad hoc basis. Employer-sponsored retirement plans typically provide 50% to 100% income protection for up to six months and long-term disability benefits of 40% to 66% inclusive of statutory benefits.	Public-sector plans increase plans according to changes in CPI. Private-sector employers are not required to make adjustments under Canadian law but the majority index pensions based on a proportion of CPI. Provided through a separate long-term disability plan.
Disability Benefit	Spouses annuity is payable if this option was elected by member at retirement.	Participants usually elect form of payment at retirement. According to the Retirement Equity Act of 1984, spousal consent is required for form of payment other than spousal annuity.	Typically a pension is paid as a lifetime, guaranteed 5 years. Most plans will provide survivor pension benefits of at least 60%
Death after Retirement			

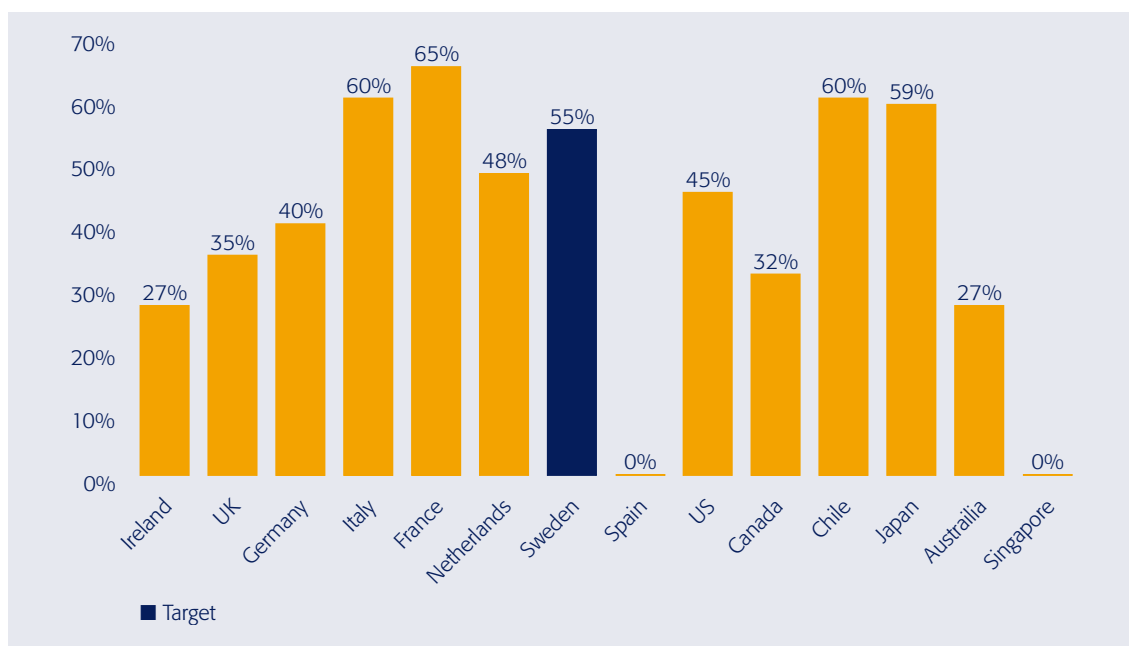
Employee Contributions	DB: 0% DC: Not required, but there is a trend to include employee contributions in qualified pension plan. Where adopted, the range is 1% to 5% of relevant salary and usually is 50% of the company contribution. The only financing vehicle that allows employees to contribute on a tax effective basis to an employer sponsored pension plan is a qualified pension plan. In the market, 50% of these plans require employee contributions.	DB: Very few plans require contributions. DC: Between 1% and 6% of pay. The trend of employee contributing more towards the cost of their benefit plans continues. The popularity of 401 (k) plans, which allow employee deferrals to be excluded from income, also continues.	DB: Between 3% and 5% of earnings. DC: Contribution levels vary by plan but legislation limits total (employer plus employee) annual contributions to a maximum of 18%.
Employer Contributions	DB: 100% of plan cost. DC: Between 1% and 2% of earnings up to the Social Security maximum base and between 10% and 12% of earnings exceeding the Social Security base.	DB: 100% plan cost plus the cost of the disability plan (insurance costs). DC: Company contribution is typically made. Sometimes employer matches employee contributions up to a specified limit.	DB: 100% plan cost net of employee contributions. DC: Employer contribution is usually based on a match of employer contributions.
Financing	Until recently, the most common method of financing supplementary pension benefits was book reserves. However, most pension plans are to be externally funded by November 16th, 2002. Nowadays, 62% of plans are financed through a pension fund and 38% are included in insurance policies.	Larger plans often place their money with an institutional trustee, usually a bank. The trustees have custodial, disbursement and sometimes investment responsibilities. Some smaller plans use insurance companies, but this is less common in the US than in Europe and elsewhere. In some instances, unfunded book reserve methods are used to finance deferred compensation arrangements, but these are not tax-qualified and are customarily confined to top executives.	Generally, Pension Funds use external investment managers, or in-house investment managers for larger funds. Medium/Small pension funds use trust and insurance companies.
Estimated Gross Retirement Income as per cent of an Average Salary Benchmark Coverage	Target is 70% including social security	Wide variety of benefits means no meaningful figure available	65% including social security
Taxation (Summary)	10%	Nearly all employees will have access to an "occupational" pension scheme, although not all employers will contribute. Approximately 40% of employees participate in a plan with employer contributions. Approximately 20% of companies still sponsor a DB pension plan.	40% in employer sponsored pension plans. Coverage would increase to 80% if RRSP (PRSA-like individual retirement savings) were included.
Taxation (Detailed)	See below Non-qualified (most schemes) – insured benefits with T-T-E Qualified schemes (big banks) – E-E-T with additional 10% bonus on contributions	Employer Contributions – Tax-Deductible Accumulation of Pension Funds – Tax Exempt Pension Income – Taxable Limits on tax-deductibility of employer and employee contributions. Approved pension plans have limits on benefits at retirement	Employer Contributions – Tax-Deductible Accumulation of Pension Funds – Tax Exempt Pension Income – Taxable Limits on tax-deductibility of employer and employee contributions. Approved pension plans have limits on benefits at retirement
Past Experience & Emerging Issues	– Banks have historical special treatment which more easily enables them to gain qualified status – Companies tend to keep their schemes non-qualified to retain better control on vesting rights for employees – There is a trend towards companies replacing benefits' formulas integrated directly with Social Security by more indirect integration	DB plans are facing a number of issues: - Increased regulation and compliance requirements - Higher funding requirements through legislative minimum contributions - Harmonisation of accounting practices leading to FRS17 type disclosures - Changes to actuarial bases leading to increased contributions This has led to the virtual absence of any new DB plans in recent years, although most companies have not yet closed their existing DB plans to new entrants. New plans are DC, either based on profit sharing or a company match to employee contributions	– The current system of provincial pension regulation is cumbersome and costly for schemes which operate across the country so there is a push to having one national pension regulator (currently 10 provinces so ten sets of regulations) – Many companies are closely examining their DB schemes and are either restructuring the DB design or switching to DC – In recent years court cases have arisen to debate scheme surplus ownership with some high-profile cases awarding surplus to employees – The government of Canada's most populous province, Ontario, intends to ban mandatory retirement rules if it wins re-election

Country of Origin	Chile	Japan	Australia	Singapore
2nd Pillar Occupational Plans Type of Plan	Too few occupational schemes in Chile for useful analysis.	Defined Benefit	Defined Benefit or Defined Contribution, although trend is towards DC. Many DB plans are closed to new entrants or have converted to DC.	Too few occupational schemes in Singapore for useful analysis.
Plan Eligibility	All regular employees from date of hire.		Membership of a superannuation fund is mandatory for virtually all employed persons in Australia. Generally all employees are required to be provided with at least a minimum level of benefits under the Superannuation Guarantee (see Statutory Requirements). Eligibility for additional benefits is at the employer's discretion.	
NRA Males		60 (at 86% of multinational companies)	65	
NRA Females		60 (at 86% of multinational companies)	65	
Pensionable Earnings		Pensionable earnings are typically defined as the monthly base pay. The definition may sometimes include monthly-paid allowances. The monthly base pay is usually defined as a factor (ranges from 1/12th to 1/20th) of total annual cash compensation. The most common factors used are 1/17th and 1/18th. For point system plans, typically pensionable earnings are accumulated total points * JPY 10,000.	Practices vary, although traditionally only Base Salary would be used.	
Final Pensionable Earnings		Final monthly base salary.	Final three-year average salary (where a DB is provided)	
Pensionable Service		All years of service.	Typically service while a member of the plan.	
Normal Retirement Benefit		A points system for calculating the benefit amount based on job grades, years of service or points of contribution etc. is becoming popular. However many companies commonly use final monthly salary for the base in calculating the benefit amount. Typical formula is: (Final monthly basic salary) x (Benefits' rate according to Years of service and Reason for termination).	Virtually all employer-sponsored retirement plans provide lump sum benefits rather than pensions. There is a strong trend to DC plans, and the majority of DB plans are closed to new employees. Many have also converted from DB to DC. DC: Superannuation plans pay the account balance as a lump sum. DB: Typical plans provide lump sums on normal retirement of about six times the final three-year average salary after 40 years' service. Lower benefit scales may apply to employees classified as "wage-earners", although the Superannuation Guarantee, which prescribes a minimum level of employer-provided benefit, will gradually reduce the scale of such differences.	
Early Retirement Benefit		With certain months/years of service employees can be eligible for a retirement benefit. Usually the necessary period of service is longer for voluntary resignation than for involuntary retirement.	Typically, early retirement is not available before the age of 55. Benefit is typically the same as for normal retirement. Where a DB is paid there may be a discount applied before age 60.	
Late Retirement Benefit		None and a deferred pension payment is not common.	Government regulations impose certain restrictions on the accrual of benefits after the age of 70, although, individuals have been able to make voluntary contributions up to the age of 75, provided they are "gainfully employed" for at least 10 hours per week.	
Pension Increases		Post Retirement Indexation: Usually, the annuity is not indexed. It is more common to apply a pension conversion rate.	Not applicable. Benefits are almost always paid as lump sums.	
Disability Benefit		Under traditional defined benefit plan, typically benefit is as per normal retirement benefit on an involuntary retirement basis.	Superannuation plans typically include a lump sum total and permanent disability (TPD) benefit that provides equivalent benefits to the lump sum death benefit (generally the prospective retirement benefit based on current salary).	
Death after Retirement		None under book reserved lump sum plan. For a tax qualified pension plan (TQPP), survivors' benefits are provided although this is typically an optional benefit.	Not provided.	

Employee Contributions	None. In principle, almost all tax-qualified corporate retirement benefit plans call for the employer to pay 100% of the contribution. Under a DB plan, it will be possible to require employees to share the cost of the plan. Employees cannot contribute to corporate sponsored DC plans. Only the company can make contributions which are fully tax-deductible up to certain limits. In case there is no other pension plan available, the tax-deductible contribution limit is JPY 46,000 per month and if there is another corporate pension plan other than the DC plan the limit is reduced to JPY 23,000 per month.	None.	DC: None, with flexibility to make voluntary contributions. DB: 5% of salary, with scope for additional voluntary contributions.	
Employer Contributions	100% plan cost. Company contributions into DB plans are tax-deductible in full as determined by the most recent actuarial valuation.		Between 9% and 11% of salaries (the minimum employer contribution rose to 9% as of July 2002) depending on the level and nature of benefits provided and the chosen funding method.	
Financing	The main methods for defined benefit type plans are book reserves as internal financing, and Tax Qualified Pension Plans (TQPP) and Employees' Pension Funds (EPF) as external financing.		Superannuation plans are always funded via a trust, whose trustees may be employees, management or a corporate trustee. The vast majority of plans must have equal employer and employee representation on the trustee board. Plans may be stand-alone, master trust arrangements, or multi-employer industry plans. The full range of funding vehicles is available, including deposit administration contracts (used by smaller plans), investment-linked managed funds and pooled funds and individual portfolio investment management for larger plans. Death and disability and medical benefits are usually reinsured, although larger plans may bear the total risk.	N/A
Estimated Gross Retirement Income as per cent of an Average Salary Benchmark	Information not readily available.	Information not readily available.	Lump sums normally provided	Due to the extensive cover provided by the statutory scheme, occupational schemes are generally only created for employees without Singaporean citizenship or permanent residency (and as such are not covered by the statutory scheme).
Coverage	N/A	90% (for companies with 1000 or more workers)	95%	N/A
Taxation (Summary)	N/A	Employer Contributions – Tax-Deductible Accumulation of Pension Funds – Tax Exempt Pension Income – Taxable	N/A	
Taxation (Detailed)	– The new system was introduced in 1989 to replace the existing pay-as-you-go system. This new system allowed current workers to opt out of the PAYG system financed by payroll tax and instead contribute to the Personal Retirement Accounts (described in detail above). Today 95% of covered workers participate in the new system. – Employer sponsored pension schemes are relatively rare but there is increasing interest among employers, particularly subsidiaries of multinationals, that for individuals earning more than the ceiling, there is greater need for supplemental provision. Few supplemental plans have been established and those that have are for senior managers.	– Defined contribution plans are now possible due to recent legislative changes. However DC plans are not yet popular due to some disadvantages: - withdrawal of accumulated contribution prohibited - employees cannot pay matching contributions - tax free contribution amount is small – The government has proposed to increase the tax free contribution limit which may lead to an increase in DC take-up.	– About a decade ago the government mandated that employers contribute at least 3% of salary toward pension provision. This prompted most companies to abandon their DB schemes and switch to a DC scheme with contributions equal to the minimum of 3%. Companies found that employees knew the new legislation assured them of a minimum employer contribution to their pension and companies did not perceive very much employee appreciation of any pension contributions above that level (i.e. toward a DB arrangement). – Another reason for the decline of DC in favour of DC was that trustees found the regulatory environment surrounding DB schemes too complex – Since this time, the government raised the minimum funding requirement from 3% to 9% and it is thought that this will rise to 12%	
Past Experience & Emerging Issues				

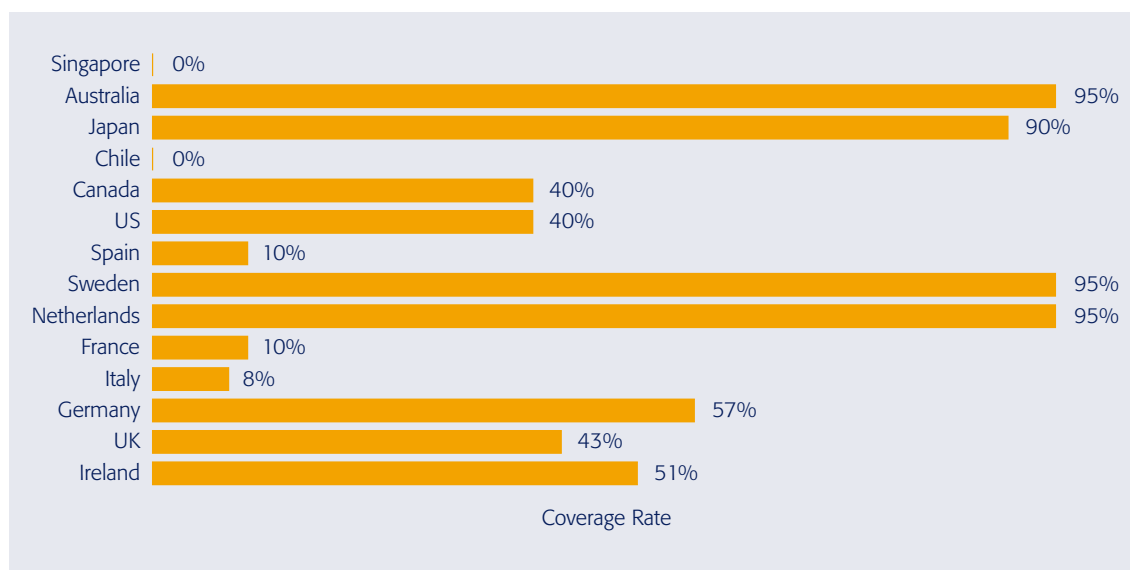
3 First pillar pension provision

1st Pillar Replacement Ratio

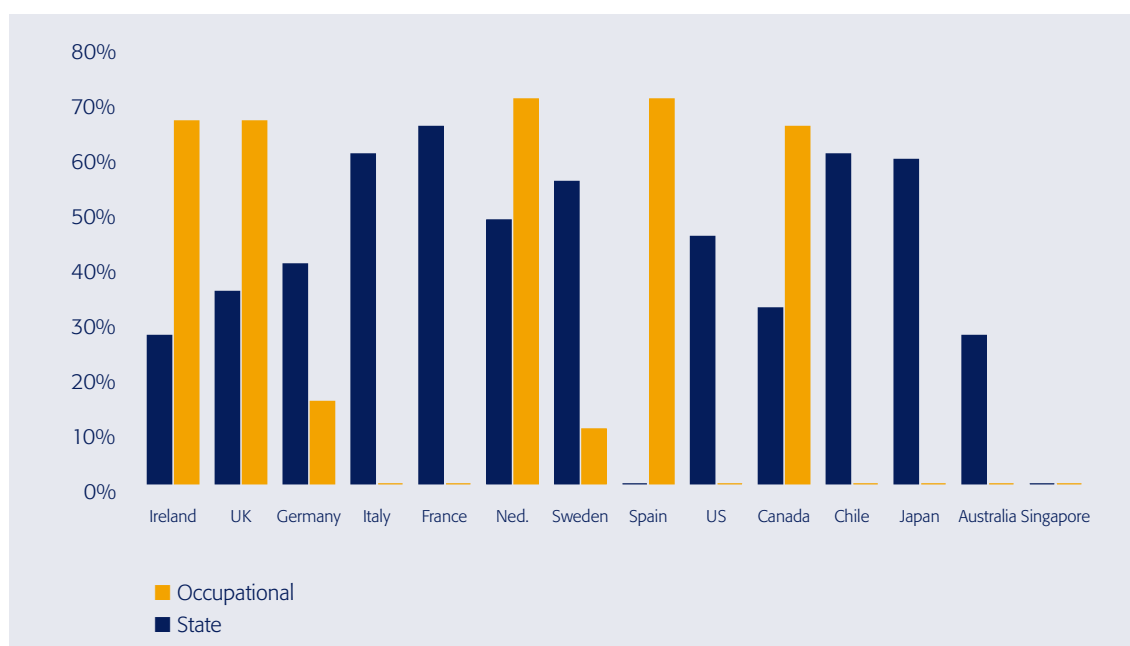


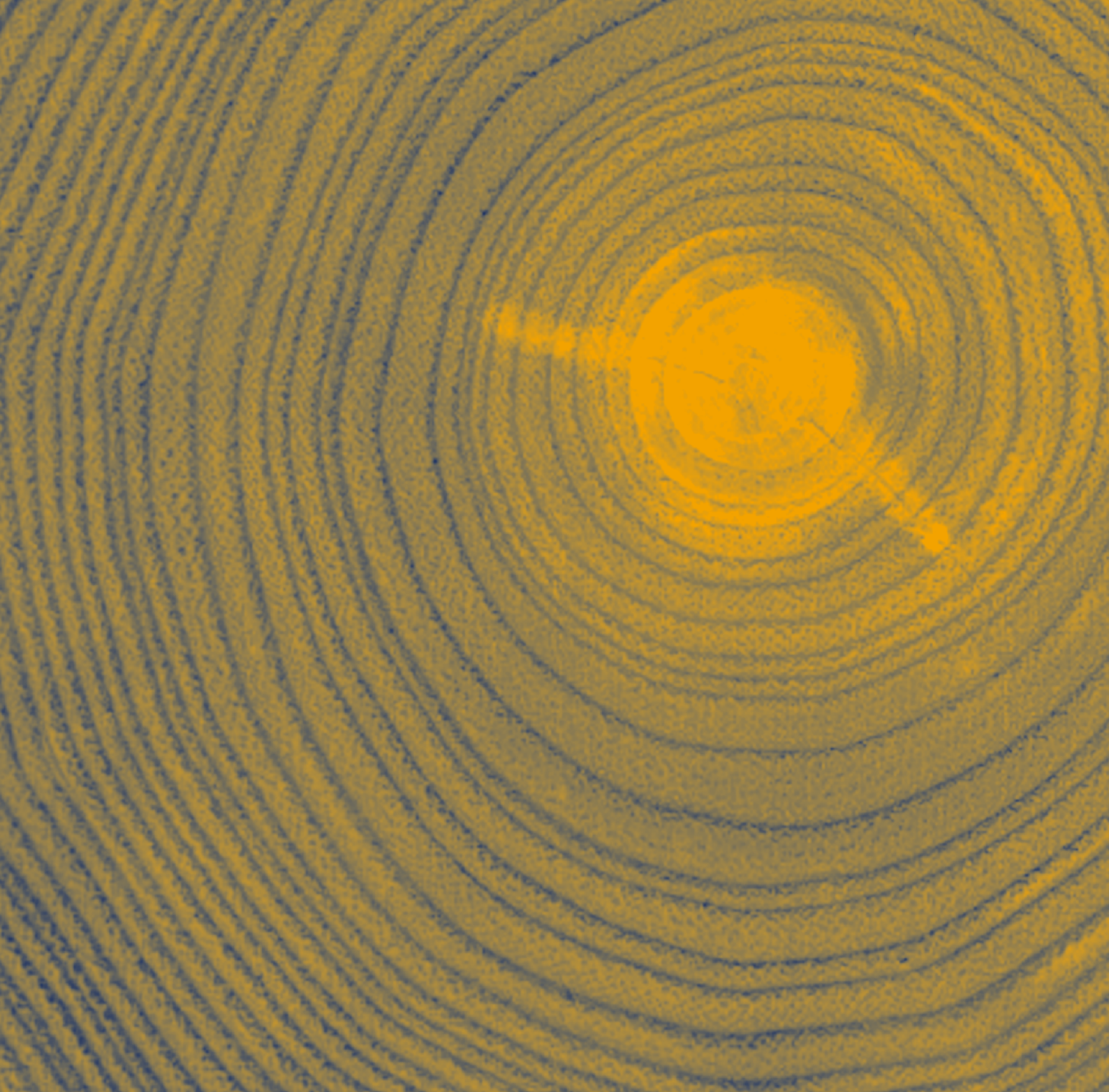
4 Second pillar pension provision

2nd Pillar – Coverage



Combined Replacement Ratio





APPENDIX 5

HEWITT ASSOCIATES REPORT ON BENEFIT OPTIONS AT RETIREMENT

MAY 2005

APPENDIX 5 – HEWITT ASSOCIATES REPORT ON BENEFIT OPTIONS AT RETIREMENT

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Prepared for
The Pensions Board

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May 2005

Introduction

Background

The Pensions (Amendment) Act 2002 introduced a requirement for a report to be made by September 2006 to the Minister for Social and Family Affairs regarding occupational and personal pensions coverage and associated matters. Minister Seamus Brennan has brought forward this review and requested that a report be made to him by mid 2005.

We have been asked by the Pensions Board to prepare a report on the structure of Benefit Options at Retirement.

Terms of Reference

Review the current arrangements for benefit provision at retirement in Ireland.

Consider what form of benefits should be available to pension savers at retirement and the extent to which savers should have discretion. Among the topics to be considered are:

- Lifetime Annuity
- Lump Sums
- Drawdown
- Dependants' Pension
- Benefits on Death after retirement

Each of the benefit options are to be considered against a range of criteria. The criteria suggested include:

- Effect on voluntary pension provision
- Savers' understanding of risk
- Advantages and drawbacks of compulsion
- Equity among classes of pension saver

References to international experience under different approaches would be helpful.

The report is not required to make recommendations, although these might be useful.

Structure of Report

The report is structured as follows:

First we set out in general terms the structure of benefit options at retirement as they currently exist.

We consider some benefit structures overseas, and identify whether there are any options which might be worth considering in an Irish context.

We then identify criteria for assessment of the various benefit options. Each of the possible options is then analysed relative to these criteria. This includes some detailed analysis of possible outcomes in relation to post retirement income under different scenarios.

Finally we draw some conclusions as a basis for discussion with the Board.

Scope of Report

In the course of considering the wider issue of encouraging pension provision in Ireland, we identified a number of topics which are outside the scope of this exercise, but are probably being addressed as part of the overall review. To ensure that we maintain our focus on the topic of this report, we have not strayed into consideration of other issues, although they are all interrelated in some way. In particular

- We are not considering whether 34% of national average earnings is a suitable target for the State pension or indeed whether it would be a suitable level of minimum income in retirement
- We have not considered the issue of access to funds prior to retirement although this has been identified as a possible incentive for increasing pension coverage
- We have not considered the type of vehicles that should be used for saving prior to retirement e.g. can PRSAs be simplified?
- We have not considered investment issues for the period prior to retirement
- We have not addressed the issue of taxation policy in relation to saving for retirement or the cost of tax relief afforded to private pension provision
- We have not addressed the balance of State and private pension provision
- We have not considered whether a change in State pension age, or some flexibility around payment of State pensions, might be appropriate
- We have not addressed the issue of extra compulsory saving for retirement, such as an increase in PRSI contributions or any other mandatory system
- We have not addressed the possible involvement of the State in second pillar retirement provision (e.g. by the establishment of a State annuity fund) which is a separate exercise.

Impact of Benefit Options at Retirement

Pension coverage can be looked at in terms of either:

- the number of people who have some form of private pension cover, and/or
- the quality or quantity of such coverage by those who have some form of private pension cover.

We refer to the former as '*pension coverage*' and the latter as the '*quality of pension coverage*'.

The impact of retirement benefit options on pension coverage and on the quality of such coverage is complex and not uniform across all individuals and all types of pension arrangements:

- the further an individual is from being able to draw on his or her pension arrangement, the less relevant the options are to them in terms of their decision making process at that time to take out or join a pension arrangement or in relation to how much they may contribute to such an arrangement.

Therefore, for example, it seems likely that the options available at retirement have little if any impact on those in their 20s and 30s where the key drivers of pension saving are likely to be affordability (including tax savings), complexity and access to funds prior to retirement.

The options available at retirement will be of more interest to individuals in their 40s and 50s, and will be very relevant to those within a few years of retirement in the context of their overall financial planning for retirement.

- The options available at retirement have had a significant effect on the proprietary director, self employed and AVC markets but mainly in terms of increasing the quality of such coverage rather than substantially increasing the actual rate of such coverage itself. So, for example, there has been a substantial increase in funds going into proprietary director, self employed and AVC pension arrangements since the lifting of the compulsion to purchase an annuity in 1999 with the introduction of the ARF option.

On the other hand, the ARF option under the PRSA has had little or no impact in terms of increasing pension coverage among those who have no coverage currently. We would not expect it to have had much impact at this early stage of PRSAs having become available.

Impact of Tax Policy

The perceived tax efficiency of different retirement options can have a significant impact on both pension coverage and the quality of such coverage, particularly among higher rate taxpayers and arrangements where there is a strong sense of personal ownership of the retirement funds, such as proprietary directors, the self employed and AVCs.

In this regard the option to take a tax free lump sum at retirement is very important to these groups as they can arbitrage between the benefits of personal tax and PRSI/Health Levy relief on pension contributions and a tax free lump sum at retirement. The benefit of this arbitrage is obviously magnified as the individual gets closer to retirement age.

The ARF option is also perceived as being 'tax efficient' to the extent that funds can be left to children at a flat tax rate of 20%.

The removal or change in existing retirement benefits options (particularly the tax free lump sum entitlement) is therefore likely to have, depending on the nature of the changes made and whether they would be backdated or not:

- little impact in the short to medium term on pension coverage take up by employees who are, say, under 40, as these are not currently influenced by the current options,
- a possible growing negative impact on pension take up by employees over, say, 40, and
- a substantial impact in terms of the quality of coverage among what might be broadly called the higher net worth self employed and the AVC markets. This, in the light of the ESRI Report (discussed below) and its conclusions about the unbalanced nature of pension tax relief, might not necessarily be a bad outcome, i.e. these people would then consume less tax relief and make such lost tax revenue available to the Exchequer for other pension related purposes, e.g. increase in basic State pension.

ERSI Report on Pensioners Incomes

A report published in May 2005 by the ESRI, "Pensioners' Incomes and Replacement Rates in 2000" puts forward a number of interesting findings in relation to what income pensioners are currently receiving:

- Average income of a pensioner unit in 2000 was somewhat over half of gross average industrial earnings;
- The main source of retirement income is provided by the State pay-as-you-go pension schemes;
- State pension schemes provided an income for more than 9 out of 10 pensioners;
- Occupational or personal pensions provided an income for only 1/3rd of pensioners. The average amount paid accounted for less than 1/4 of average income during retirement;
- Occupational or personal pensions provided virtually no income during retirement for pensioners in the bottom 3/5ths of the income distribution;
- The tax foregone in order to support the private pension system in 2000/01, €1.5 billion compares to direct expenditure on the public pension system for the elderly of €1.6 billion.

Clearly, there is scope to improve private pension provision and ensure that it provides a greater proportion of retirement income in future. It is also obvious that private provision needs to be extended to cover a greater proportion of the population than at present (i.e. those in the lower and middle income groups) if the State is to keep down its long-term pension costs. Of course an alternative would be for the State to boost the basic State Pension and reduce the cost of private pension reliefs. However, discussion of this issue is outside the scope of the report.

SSIAs

Although not directly relevant to the topic of this report, there is recent evidence to suggest that individuals can be encouraged to save. Witness the SSIA story. Over a period of just 5 years, the nation has been encouraged to amass assets to the tune of €15 billion. The success of the SSIAs may be attributed to a number of factors:

- A very clear tax benefit;
- Simple, easy to understand products;
- A large network of distribution channels through which the products could be purchased;
- Funds only temporarily inaccessible. If an individual absolutely wished to access their funds before the end of the 5 year period, this was in fact possible, albeit subject to a penalty;
- Universal access – there are no complicated rules about who is eligible to take one out;
- A simple regulatory system – for example, Statements of Reasonable Projections, etc are not required;
- Product branded as a savings plan rather than a pension plan.

Some of these “selling points” might translate to pension design, both in the accumulation period before retirement, and the drawdown period after retirement.

Current Irish arrangements for benefit provision at retirement

Introduction

In this section we look at the options currently available at retirement.

The options essentially are to take part or all of the available funds in cash, and to take any balance as ongoing income. In general, cash can only be taken at retirement, and once ongoing income is elected, this cannot subsequently be reversed. However, the introduction of ARFs has provided greater flexibility in this regard.

It should be noted that some (generally more wealthy) individuals save for retirement outside the conventional pensions system by investment in property, shares, a farm or a family business. Income in retirement may be obtained from these assets e.g. rental income, dividends on shares etc but such individuals might also wish to have access to retirement options e.g. the facility to transfer the ownership of a property into an ARF.

For those at the lowest income levels, if the State pension or means tested State benefits are intended to provide adequate replacement income, options at retirement will not be relevant to them.

Approved Retirement Funds (ARFs)

Approved Retirement Funds (ARFs) were introduced in the 1999 Finance Act. These products allow individuals to maintain ownership of their capital in retirement, while living off the interest generated or drawing down some capital from time to time.

An ARF is a fund managed for an individual by a qualifying fund manager such as a bank, building society, credit union or life assurance company. ARFs taken out since 6 April 2000 can earn investment return free of income and capital gains tax. Income tax is payable on withdrawals of capital and interest from the account during the lifetime of the ARF holder.

An Approved Minimum Retirement Fund (AMRF) is similar to an ARF except that capital cannot be withdrawn prior to age 75, although interest may be paid out of the account.

On death, funds held in an ARF or AMRF form part of the individual's estate and are passed on to the individual's dependants.

It is possible to transfer funds to an ARF at retirement in the following circumstances and subject to the individual satisfying the conditions described later:

- PRSA funds
- Funds from personal pensions
- Funds from Retirement Annuity Contracts or other self-employed arrangements
- Funds in respect of a proprietary director (greater than 5% shareholding)
- Funds in respect of AVCs.

The conditions that must be met in order to transfer funds to an ARF at retirement are currently:

- a guaranteed income for life of at least €12,700 per annum (Social Welfare benefits currently in payment may be counted but excluding any amounts payable in respect of a dependant) OR
- holding a minimum of €63,500, until age 75, in an AMRF OR

- at least €63,500 has been used to purchase an annuity OR
- the individual is over 75.

The IIF have provided us with details of ARF and annuity purchases from life assurance companies from 1999 to date. These statistics are summarised in the table below. The statistics exclude ARFs held with stockbrokers and it is likely that the amounts held here are substantial.

Over the period in question there has been a steady increase in the number of policies sold at retirement (both annuities and ARFs). Apart from the year of introduction (1999), more than half of the retirement policies sold every year since then have been for ARFs rather than annuities.

Years	1972 FA Annuities		ARF	
	No. of Policies	Premium €000s	No. of Policies	Premium €000s
2004	1,262	103,361	1,979	295,139
2003	1,099	102,452	1,572	400,411
2002	1,715	151,819	1,540	214,779
2001	1,155	116,748	1,321	166,650
2000	1,076	100,212	1,403	149,144
1999	1,661	118,116	169	23,012
1998	1,507	172,102		
Total	9,475	864,809	7,984	1,249,135

The average amount paid into an ARF based on the IIF statistics is €150,000. However, as this figure does not include funds invested with stockbrokers, the true average may be substantially higher.

Since 1999 there has also been a steady and substantial increase in the funds available at retirement. Whether this is down to improved savings habits, good investment strategy and rewards or due to the introduction of ARFs is difficult to say. However, it is difficult to dispute that the introduction of ARFs as an alternative to annuity purchase has made pensions more attractive to many individuals, especially the self employed or controlling directors.

When ARFs were first introduced, there were concerns expressed that this option could lead to people dissipating their retirement funds very quickly, and having to rely on State support in old age. Alternatively, for those who decided to retain the bulk of their capital invested, the selection and monitoring of an appropriate investment strategy would be difficult, and would be likely to need expensive professional advice.

A Working Party of the Society of Actuaries in Ireland prepared a paper which recommended that those who would be relying on an ARF for a reasonable level of retirement income would probably be better advised to purchase an annuity, because of the significant probability of "bomb-out" i.e. the ARF would be exhausted before the death of the member.

Evidence to date suggests that many ARF holders have to date not been relying on these assets to support themselves. We are advised that drawdown from ARFs held with stockbrokers is low. Irish Life have advised that in 2004, the average rate of drawdown was 7% (this is over a portfolio of €100 million in assets). This rate is below their expectation of what individuals might draw down when the products were initially launched.

Fears that individuals would quickly deplete all their retirement assets have thus been unfounded so far.

There was an expectation initially that the ARF facility would be extended to all pension arrangements (or at least to all defined contribution ones) but this has not transpired. It seems reasonable to presume that if the facility were more widely available, it would be taken up by many retirees who satisfy the criteria and could have the effect of increasing saving for retirement.

Even in cases where the ARF facility is in theory available, in practice, the ARF option cannot be availed of as the individual does not have sufficient income or assets invested in an AMRF or annuity. This could be amended by reducing or removing the limits. However, this could increase reliance on the State means tested benefits if retirement assets were dissipated too quickly.

Anecdotal evidence suggests that where smaller amounts are transferred to an ARF, these are generally taken as a taxable lump sum.

The paper prepared by the Society of Actuaries referred to above also pointed out that the AMRF amount of €63,500 was substantially lower than would be required to purchase an annuity of €12,700, and should be increased if it were intended to be an equivalent option. In view of the increase in annuity costs since 1999, this point is even more valid today.

State Benefits

For those who have paid sufficient PRSI contributions, the State provides a guaranteed pension for life. It is intended that the state pension will be indexed so that it maintains a ratio of 34% to national average earnings. Survivor's pensions may also be payable following death. Payment commences at age 65 and it is a condition that the individual is no longer gainfully employed. Payment will be made from age 66 in any event.

For those not eligible for the contributory pension, means tested pensions may be paid. These are payable from age 66.

In certain circumstances other non cash benefits may be provided – for example, free travel pass, fuel allowances, telephone allowances, free television licence, medical cards (everyone over 70 irrespective of means).

Public Sector Occupational Pension Scheme

These are defined benefit arrangements providing a cash sum at retirement and an income for life. Pensions in payment are normally indexed to the earnings of current public servants. Spouses' pensions on death in service and retirement are payable. Similar arrangements apply in some semi-state bodies, and related employers.

AVCs paid to purchase added years cannot be transferred to an ARF, however, money purchase AVCs may be transferred to an ARF at retirement. Otherwise, there are no options to be exercised at retirement.

Occupational Pension Scheme – Defined Benefit

Typically benefit is provided in the form of an income for life. Some schemes may offer a lump sum in addition to the pension, or members may have the option to exchange part of their income for life for a cash lump sum. Survivor's pensions are also usually payable and there may be a lump sum death benefit. Depending on the rules of the scheme, the pension might be indexed in line with inflation (usually subject to a cap), at some guaranteed rate e.g. 3% or level in payment.

Schemes generally permit early or late payment of retirement benefit, suitably adjusted. Normal Retirement Age is typically in the range 60 to 65.

Other options that are provided in some cases include the member having the option to give up part of their pension for additional survivor's pension or, if retiring before 65, being able to have a higher initial pension that reduces once State Pension Age has been reached.

Revenue imposes limits on the maximum benefits that may be paid from an approved scheme. Very broadly, provided 10 years' service has been completed, a pension of up to 2/3rds pay prior to retirement may be provided. The amount that may be taken as a tax free lump sum is limited to 1.5 times pay prior to retirement (provided at least 20 years' service have been completed).

The main decision which members need to make at retirement is whether to surrender pension for a cash sum (if this is an option) or to retain the full level of pension. Where AVCs have been paid on a money purchase basis, these would usually be taken as tax free cash up to the Revenue limit, and any excess transferred to an ARF or used to purchase additional pension (which may be the only practical option if the excess is low).

We believe that in the vast majority of cases, retirees take a lump sum at retirement, usually at the maximum level permitted by Revenue or under the Rules of the scheme, if more restrictive. This tends to be the case even where the terms for exchange ("commutation factors") are not particularly generous, which would be the case for most schemes at present, at least by comparison with annuity rates. Those who commute may also be giving up the prospect of future discretionary increases in pensions.

While it is clear that the tax free status of the lump sum is an attraction, it is likely that commutation would be selected by a large number of people even if the lump sum payment were taxed in the same way as pensions. Reasons for this would include the ability to pay off loans, make significant once-off purchases and the "bird in the hand" syndrome. There is evidence that people in the UK considerably underestimate their average life expectancy and this would help to make the lump sum appear more attractive.

Occupational Pension Schemes – Defined Contribution

Benefits at retirement are based on the value of the member's account at retirement. Part of the fund may be taken tax-free (same limits as for defined benefit members) and the balance must be used to purchase an annuity, generally on the open market.

When purchasing an annuity, members may select a specified guarantee period, survivor's pension and rate of increase in payment.

Retirement Ages and Revenue limits are the same as for defined benefit members.

In this case, the member has a cash fund and needs to convert part of this to income. This will be done on market annuity rates (apart from a small number of schemes which offer annuities from the fund) so the impact of low interest rates and increased longevity assumptions are borne by the member. It would be usual to take maximum cash and it is likely that if an ARF option were available in respect of the balance of the fund, this would be attractive to many.

AVC Benefits

Benefits in respect of AVCs may be taken in the same form as the benefits from the main scheme. However, there is a further option in that provided certain criteria are met (which will generally be the case if the main scheme provides a reasonable level of pension), the member may transfer their AVC fund to an ARF.

The availability of an ARF option, coupled with the increase in the percentage of salary which may be paid as tax deductible contributions, has made AVCs more attractive and it is likely that amounts paid as AVCs in recent years have increased, although there are no available statistics to confirm this. However, by definition, anybody paying AVCs must have a pension already and hence anything which makes AVCs more attractive will not increase the number covered by pensions although it will improve the level of pension they enjoy.

Retirement Annuities

Such retirement benefits are on a money purchase basis. Benefits at retirement depend on the amount of money invested, the returns achieved and the cost of providing benefits at the point of retirement.

At retirement, up to a quarter of the fund may be taken as a tax free lump sum and the balance must be used to purchase an annuity on the open market.

Subject to meeting certain criteria, the entire fund could be transferred to an ARF.

An individual cannot generally draw benefits prior to age 60.

PRSAs

These have similar conditions as apply to retirement annuities. Where the individual is an employee, early retirement from age 50 may be permitted.

International experience

Introduction

In the sections below we summarise some of the options available in other countries, where these may be of interest in the Irish context. We have not carried out a comprehensive review of benefit options available in all foreign jurisdictions.

United Kingdom

A personal pension holder can delay drawing on income before age 75, and there are a number of other options available. The main variants are:

- a) Annuities with guaranteed rates
- b) With-profits annuities
- c) Unit-Linked annuities
- d) Phased Drawdown Plan, also known as staggered vesting
- e) Income Drawdown Plan (IDP), also known as Income Withdrawal Plan (IWP)

The following summaries are brief overviews of these products.

- a) **Annuities with guaranteed rates:** Guaranteed income, either level or with fixed increases or full or partial inflation linkage.
- b) **With-profit annuities:** A low level of guaranteed income. Annual reversionary bonuses are then declared each year to augment the basic income (there may be a guaranteed level of bonus). Once granted a slice of bonus income becomes guaranteed for the rest of the policy. Other variants start with a higher initial level of income of which only a proportion is guaranteed for the second year. Similarly, only a proportion of the income in the second year is guaranteed in the third. The rest is expected to be made up from new bonus, but this is not guaranteed.
- c) **Unit-Linked annuities:** These annuities offer the prospect of higher income at the discretion of the insurer. Smoothing should avoid significant variations in annuity payments.

The level of income is linked to the price of units in some unit-linked funds of the insurer. There is generally some choice of unit fund and the ability to switch from one to another. This avoids being tied to initial gilt yields, but clearly can lead to volatile income payments.

- d) **Phased Drawdown Plan:** This involves segmenting the personal pension pot into many small policies. Benefits (lump sum and annuity) may be drawn from each segment independently of the others, rather than taking a single initial lump sum and a single annuity. The segments may be left untouched up to age 75 or used earlier to increase income. Until a particular segment is drawn upon it may remain invested in equity funds.

Staggered vesting gives greater control than a), b) or c), but has drawbacks. The tax-free cash sum cannot be taken all at once without the rest of the fund being used to buy an annuity, and there would otherwise be continuing investment risk.

- e) **Income Drawdown Plan (IDP):** The structure of an IDP is as follows:

- immediate tax-free cash sum, of up to 25% of the fund
- an income drawn from the remaining fund, variable within limits
- continued control of the investment of the remaining fund
- eventual purchase of an annuity, no later than age 75

On death of the member during the deferred period, broadly similar options apply to benefits available to a surviving spouse or dependant. The main difference is the ability to take the remaining fund as lump sum, but this is subject to tax and must be exercised within two years of the member's death.

There are significant investment related risks with an IDP, as the size of the final annuity depends on investment returns geared up by the income withdrawn.

A further point to note is that the individual suffers "mortality drag". In a conventional annuity the amount of income received by an annuitant who remains alive contains an element of cross-subsidy from those who bought annuities but have died. A policyholder in good health who elects instead for income withdrawal will not receive this subsidy but instead retains a substantial death benefit. The loss of the subsidy (from the annuitant's point of view) can be expressed as an annual percentage rate by which the net investment performance of the remaining pension fund would have to exceed the interest rate implicit in an annuity in order to break even. It has been estimated at 1% pa at age 60 increasing to around 4% pa at age 75. The effect of the expenses of running the investment portfolio/IDP would be in addition to this.

Chile

The social security program in Chile is based on a defined contribution pension system with mandatory employee contributions. Employers do not contribute. Private trust fund administrators known as Administrados de Fondos de Pensiones (AFPs) administer the program.

Benefits

All funds in the AFPs are indexed to inflation; they are denominated in development units (UF), which are adjusted on a monthly basis.

Old Age Pension

Eligibility

The normal retirement age is age 65 for men and age 60 for women, with a least 20 years of contributions in an AFP.

Effective August 2004, retirement at an earlier age is permitted if the participant's accumulated assets are sufficient to purchase an annuity at least equal to:

- 70% of the average of the employee's indexed covered wages for the last ten years; and
- 150% of the minimum old age pension.

Amount

The employee's contributions to the AFP are credited to an account for the employee. The accounts are credited with interest annually. The rate of interest credited varies according to the investment earnings of the AFP. The annuity paid by the AFP at the time of retirement will depend on the employee's total accumulated fund balance.

Contributors to the old social security system received a "recognition bond" from the Government to account for the value of their contributions to the old system. It is redeemed at retirement, and the value of the bond is added to the assets in the account to calculate the retirement benefit.

At retirement, the participant may choose one of three options:

- The AFP may transfer the lump-sum balance to an insurance company of the employee's choice to purchase a monthly pension for life. The pension must be indexed and provide a least a 60% continued pension to the family upon death of the insured.
- The fund balance may be kept with the AFP, and the participant is entitled to make scheduled withdrawals on the following formula:
 - First year: Amount paid is the balance divided by the life expectancy at the participant's current age. Payment is made on a monthly basis and adjusted for inflation.
 - Subsequent years: The remaining account balance (the prior balance plus interest plus monetary correction less benefits paid) is recalculated annually based on the life expectancy of the participant as of the recalculation date.
- A combination of the first two options, whereby a single premium life annuity is purchased, and the remainder of the balance in the AFP is paid out as scheduled withdrawals.

While the first option results in a fixed-UF benefit, the benefit payable under the second and third options generally will increase with age.

Participants may withdraw excess assets from the account under the following two conditions:

- The account balance provides an annuity greater than or equal to 120% of the minimum guaranteed pension; or
- There are sufficient assets left in the account to make scheduled withdrawals of at least 70% of the participant's prior indexed covered wages.

The asset accrued from voluntary contributions can be combined with the mandatory contributions for the retirement benefit. Alternatively, those amounts may be withdrawn at retirement.

If a participant is taking scheduled withdrawals and exhausts the assets in his or her account (by living longer than the life expectancy used in the formula) and has no other income in excess of the minimum pension, the government will continue to pay the minimum guaranteed pension for life. A retiree who meets the contribution requirements, but has had very low earnings for his or her whole career, is also entitled to a pension of at least the minimum guaranteed amount. The Government will continue to pay the minimum pension when the assets are exhausted.

If the participant has purchased an annuity with the pension account balance, the Government guarantees the annuity in the event of bankruptcy of the insurance company. The guarantee equals 100% of the minimum guaranteed pension, plus 75% of the remaining payable benefit, up to a maximum guarantee of 45 UF per month.

The following is taken from an OECD report – Annuities in Comparative Perspective: Do Customers get their money's worth? Estelle James and Dimitri Vittas (1999):

"In Chile there was no annuity business prior to the new AFP system, but that has changed drastically. Currently, when workers retire in Chile they are required either to leave their money in the AFP for programmed withdrawals, to take an immediate annuity, or to purchase a deferred annuity with programmed withdrawals in the meantime. Keeping money in the AFP allows it to earn a risk premium but the annuity option provides investment and longevity insurance. Annuities have other advantages: if a worker has enough savings to purchase an annuity that exceeds 50% of his average wage over the last 10 years, he can "retire" early and stop contributing to the mandatory system, while continuing to work. If the annuity exceeds 70% of his average wage, the rest can be taken out as a lump sum – he can get immediate access to his retirement savings. As a result of these incentives, the annuity business has grown dramatically in Chile. Its reserves have risen from US\$1.5 billion in 1988 to US\$7.7 billion in 1998 and are expected to reach US\$37 billion in 2010."

Another OECD report published in 2001 states that in 1996, according to data provided by the pension fund regulator, 64% of all retirees in the system chose annuities, 3% chose the deferred annuity option and the rest chose programmed withdrawal.

Australia

There are 3 elements to retirement incomes in Australia. These are:

- The age pension (social security pension, subject to an income and/or assets test)
- The compulsory superannuation guarantee system “Super” (these are usually defined contribution funds but may be defined benefit. There are minimum mandatory employer contributions)
- Voluntary savings (additional Super contributions or other means of saving).

Super benefits may be paid as an income or as a lump sum or as a combination of both.

Lump sum payments up to certain limits may be paid tax-free and are taxed above these limits. Funds in respect of contributions that had already been subject to tax are returned to the member untaxed.

If instead or as well an individual wishes to provide a retirement income stream, they can use their funds to purchase Lifetime, Life Expectancy and Allocated annuities or pensions.

There are a wide variety of options for purchase of a stream of income in retirement. Subject to certain limits, annuities can be purchased to provide lifetime income, or income for a fixed period.

Variable annuities such as the MLIS – Market Linked Income Stream are also possible – where the income may depend on the performance of the underlying assets. The fixed term of these annuities must be for whole years within the range of the life expectancy of the individual, or their life expectancy as if they were five years younger. Investment performance affects the balance of the account and so the income can rise or fall from one year to another.

An allocated pension or annuity is a series of regular payments, comprising capital and earnings, payable directly from money held in a personal account in a superannuation fund. The payments receivable can be varied within minimum and maximum limits. These limits are designed to ensure that the capital is drawn down over time and provides some income until at least age 80 years. Payments cease when the funds in the account are used up.

When purchasing an annuity, it may be possible to provide for a survivor’s pension and/or indexation, depending on the particular product chosen.

We have not been able to source statistics in relation to choices elected by individuals at retirement. However, quoting from an OECD 1999 report:

“...the Australian annuity business is developing only now, as a consequence of its new superannuation scheme, which requires workers to accumulate large retirement savings that they can then use either in gradual withdrawals or in annuity purchases. In Australia in 1994, when this scheme started, assets backing life annuities were only A\$1.3 billion or 4% of non-superannuation assets in life assurance companies, whereas by 1998 they were A\$3 billion, over 10% of non-super life insurance assets.” Part of this shift was due to gradual changes in the relative tax treatment of annuities and phased withdrawals.

Comments

The elements of the above systems which might be worthy of consideration in Ireland are

- Controlled drawdown as in Chile and UK
- Unit linked annuities
- With profit annuities (these were available from Equitable Life)
- Taxable Lump Sum Option (this is currently available to certain classes of saver via the ARF route. However, we mention this separately to consider whether this should be extended to all categories of saver and pension savings).

Criteria for analysis of benefit options at retirement

Selection of Criteria

The objective of the Review is to identify ways in which pension coverage can be increased, and in this report we are considering whether the options available at retirement should be amended or extended to encourage take up of pension. We now need to develop criteria for assessing whether the various options which are or could be made available would be likely to increase pensions take up.

The terms of reference list the following criteria

- Effect on voluntary pension provision
- Savers' understanding of risk
- Advantages and drawbacks of compulsion
- Equity among classes of pension saver

We assess whether the introduction of additional options, or amendments to existing options, would be likely to increase pension coverage. As the existing options would presumably continue to be available, we do not consider the possibility of a negative impact on coverage.

Effect on Voluntary Pension Provision

We have considered this by examining criterion such as simplicity, flexibility, perceived value for money and control over the assets.

Savers' Understanding of Risk

Currently the range of options open to individuals at retirement may require the individual to make one or more choices related to the following:

- tax free cash versus taxable pension/annuity
- taxable cash versus taxable pension/annuity
- AMRF versus annuity
- ARF versus taxable pension/annuity

Individuals faced with one or more of these choices should ideally consider many factors including:

- Current state of health. How long is he or she likely to live?
- Is the rate of exchange offered by the pension arrangement between pension and cash fair value for money?
- Current marginal tax rate if taxable lump sum taken
- Anticipated marginal tax rate on pension/annuity income, if taken
- Total income requirements in retirement
- Total assets available to provide income in retirement, including retirement funds

- What level of investment return can be earned on invested funds, given the individual's attitude to investment risk
- Will his spouse/partner need income should he predecease her
- Does he want to leave retirement assets to children or other dependants?
- What level of increase will there be in his/their outgoings in retirement?
- Will he or his spouse/partner have additional healthcare requirements in later years?

In reality the decision making process used by retirees with regard to their retirement benefit options is often guided by perception and emotive factors, rather than on any hard factual independent analysis, as

- Some of these factors are incapable of accurate prediction in any event, e.g. how long will I live?
- Lack of access to competent professional independent advice; this is particularly relevant to the non self employed market who are unlikely to want to pay fees for independent advice rather than being sold a product.
- Lack of skills and experience in the advisor market in relation to retirement benefit options. Most 'advisors' in reality will attempt to sell the ARF option in any case where this is an option for the client without doing any annuity versus ARF analysis for the client. Many advisors are product sellers and ARFs are a more lucrative product sale for the advisor than an annuity or pension.

Most individuals will need advice in relation to appropriate investment policies if they are intending to retain control over their own assets in retirement, and a proper understanding of the volatility of different asset classes, particularly if they wish to be able to draw down income as required.

In relation to mortality, there is evidence in the UK that most individuals underestimate how long they are going to live ("How long do people expect to live? Results and Implications" CRIS Research, March 2005). Individuals need to be aware of the risks they are taking by drawing down income at unsustainable levels.

When ARFs were introduced, there was a fear that pensioners would quickly deplete their retirement assets and be solely dependent on the State for retirement income. Experience to date does not back this up – although the time period since their introduction is too short to draw any meaningful conclusion in this regard.

We consider that if complex options are available to individuals at retirement, proper explanation and disclosure of the risks should be required, although this may increase the costs of providing these options. An alternative view would be that it is better to protect individuals from themselves by limiting the options available to those which can be readily understood i.e. cash or guaranteed income.

Advantages and Drawbacks of Compulsion

The reference to compulsion could be interpreted in two different ways:

- Compulsory saving for pension e.g. a statutory requirement for employers and employees each to contribute 5% to a pension fund
- Requiring part or all of the benefits at retirement to be taken in a particular way e.g. the purchase of a guaranteed annuity

We have assumed given the context of the report that it is the second issue which we should consider.

At present, there is a choice at retirement between cash (up to a specified limit) and income, and for members of defined contribution arrangements there would normally be a further choice between level and increasing pensions, and between single or joint life. Some people have a further choice, provided they have a minimum level of income or sufficient investment in an AMRF, to transfer their funds to an ARF.

It seems likely that removing or reducing this level of choice would have a negative impact on pension coverage. In particular, any change to the existing facility to take a tax free lump sum at retirement could be detrimental. Similarly, given the take up of ARFs, any restriction of the flexibility available under the current regime would be unpopular.

At one extreme, there could be a requirement that all retirement benefits had to be taken in the form of guaranteed lifetime income, and at the other extreme there would be no compulsion at all i.e. cash could be taken at retirement, or as and when required thereafter (with appropriate tax treatment). This latter approach might be considered appropriate if the State pension was considered to provide an adequate level of retirement income. This approach broadly reflects the current ARF facility, with the removal (or upward adjustment) of the AMRF requirement which would currently provide income substantially below the level of the State pension.

We consider that any reduction or restriction in the choices available at retirement, or any additional compulsion in relation to the options to be exercised, would be detrimental to pension coverage, assuming that saving for retirement remains voluntary. If there are other policy or fiscal reasons for introducing restrictions or some additional degree of compulsion, the benefits of this would have to be weighed against the likely negative effect on pension coverage.

Equity Between Classes of Saver

It is difficult to assess each of the options separately according to this criteria. This might refer to whether, for example, the ARF facility should be extended to all classes of pension saver or indeed whether the criteria should be relaxed so that all individuals, irrespective of their wealth, could avail of the facility.

We consider this to be a more general issue rather than specific to any particular option and discuss it later in the report.

Tax Policy

Fiscal policy is similar to compulsion in that if some options at retirement receive more favourable tax treatment, individuals are more likely to elect these options. The facility to take tax free lump sum rather than taxed pension is attractive, and it is likely that if the balance were tipped the other way, a significantly lower proportion of retirees would elect to take cash.

If it were considered desirable for individuals to take retirement benefits as pension rather than cash, tax policy could encourage this by

- Imposing a tax on lump sum benefits at retirement
- Providing more favourable tax treatment for pensions e.g. a special tax credit or a “capital content” treatment similar to purchased life annuities

We have not considered this issue further and are not suggesting that this would be an appropriate way forward in the context of increasing pension coverage.

Additional Criteria

In assessing the options, we felt that the following additional criteria should be considered:

- Simplicity
- Flexibility
- Perceived value for money
- Control over assets

Simplicity

There are indications that the complexity of pensions is off putting for some individuals. Simpler easier to understand products may enhance pension provision. Based on a survey commissioned by Indecon for their report "Review of Potential Options to Encourage Increased Pension Coverage", March 2005, 57% of respondents considered that complexity of pensions is a potential barrier to increasing pensions coverage in Ireland.

Simplicity would be desirable in relation to the options available at retirement, although less important than simplicity before retirement.

Flexibility

Flexibility includes being able to move from one benefit option to another – for example switching from a variable to a guaranteed annuity. It also includes being able to choose and vary at what point retirement benefits are drawn.

Perceived Value for Money

Consumers need to see value for money in how their benefits are provided. Conversion of capital to an income stream (fixed, for life, temporary or other) needs to be on terms attractive to the consumer.

Similarly, it might be considered appropriate to convert income to capital on terms attractive to the consumer. However, evidence from defined benefit schemes in relation to the commutation of pension for cash often on poor terms does not seem to prevent selection of this option. This could be due to a lack of awareness of the value of the benefit being given up or due to the "bird in the hand" syndrome.

Control Over the Pension Assets

The recent ARF take up confirms that consumers prefer to retain ownership of their assets after retirement rather than using their retirement funds to purchase an annuity (although this may partly be due to the perceived "poor value" of annuities at current interest rates).

Security of Income

The key point in assessing the merits of any particular option, is in determining whether the option itself will help provide an individual with either sufficient income or capital to see them through their retirement. In the tables later, this is referred to as "Risk".

Consideration of options relative to criteria

Options Considered

We now discuss a number of benefit options and how each of them meet the criteria suggested above.

Lump Sum at Retirement

Currently it is possible to take part of retirement benefit as a tax free cash sum (the exact amount depends on the regime through which the individual has been saving). As noted previously, this is popular because of the favourable tax treatment and also because it provides immediate access to capital which may be required. However, if the cash is obtained by commutation of pension from a defined benefit scheme this may not provide good value for money.

Note that it is also possible for some individuals to avail of this option on a taxed basis, via the ARF route.

In summary, this can be assessed against the criteria as follows

Simplicity	This is the easiest benefit to understand.
Flexibility	There is complete flexibility for the consumer here as once he has the cash, he can spend/invest it as he wishes. If he decides subsequently that he wants guaranteed income, he can purchase an annuity although this may not be on the same terms as at retirement.
Value for money	May not be good value if obtained by commutation of a defined benefit pension
Control over assets	The consumer has complete control over the cash sum taken
Risk	Taking cash and spending it may mean that the residual income is insufficient to meet the individual's needs in retirement.

Guaranteed Income for Life

This could be provided as a pension from a defined benefit scheme, an annuity purchased on the open market or on a Pay as You Go Basis as for state benefits and public service pensions.

A guaranteed annuity insures against both investment risk and longevity risk. However, without some level of indexation, it does not provide any protection against the loss of purchasing power of the retirement income.

Provided the initial income is at an adequate level and maintains its value in real terms, this can meet the needs of many investors. There is a perception that pensions are expensive to buy, but perhaps this is as a result of underestimating how long retirement might last. A male aged 65 purchasing a fixed single life pension would receive a guaranteed income for life of about 7% of their fund at retirement. A male aged 65 purchasing a pension increasing in line with price inflation would receive a guaranteed index-linked income for life of about 4.7% of their fund at retirement (source Irish Life annuity quotes April 2005).

While such a return may appear low, the latter is a return in excess of inflation, is guaranteed and ensures that the individual has an income for life, no matter how long they live.

We discuss further in the next section whether index linked income is the most appropriate choice for consumers. In this connection, it may be noted that recent legislation in the UK has removed the previous statutory requirement there that annuities be purchased on an index linked basis for funds from money purchase arrangements.

One issue which should be borne in mind is that insurers underwriting annuities may anticipate adverse selection if other options are widely available i.e. those who expect to live longest will buy annuities. This could lead to a further hardening of annuity costs.

We have not considered in this report the possibility of guaranteed conversion terms being available – where such conversion terms were underwritten by the State. This will be considered as a separate part of the Review.

In summary, this can be assessed against the criteria as follows

Simplicity	This product is relatively easy to understand.
Flexibility	There is very little flexibility for the consumer here as once the capital is paid there is no possibility to retrieve the capital.
Value for money	There may be a perception that annuities do not provide good value for money. This may be due to a lack of understanding about life expectancy. It may be true to the extent that providers must generally back annuities with fixed interest stocks.
Control over assets	The consumer has no control over assets once the annuity has been purchased.
Risk	Income is secure for the lifetime of the individual (subject to the very small risk of insolvency of the insurer).

Temporary annuity

An annuity which pays income whilst an individual is alive, but which terminates after a fixed term, might be attractive as a guaranteed income for that period could generally be provided for a lower capital cost than if the income were guaranteed for life. If this option were available at retirement, the individual would be able to guarantee income for a period, and retain the balance of capital invested, and use this at the end of the period to secure further income. On death within the term of the annuity, the residual capital would be available to the estate.

Index Linked Annuities

The ESRI research referred to earlier suggests that older pensioners have lower incomes relative to average gross industrial earnings than younger pensioners. This is because not all pension income is index linked. Further, research has also shown that a greater percentage of pensioners than of other adults live in poverty.

Maintaining the real value of a pension once in payment is therefore important. However, it does raise significantly the cost of purchasing a pension at retirement. For example, for a male aged 65 at retirement, a pension increasing in line with price inflation would be approximately 50% more expensive than a pension that did not increase at all. (source Irish Life annuity quotes April 2005).

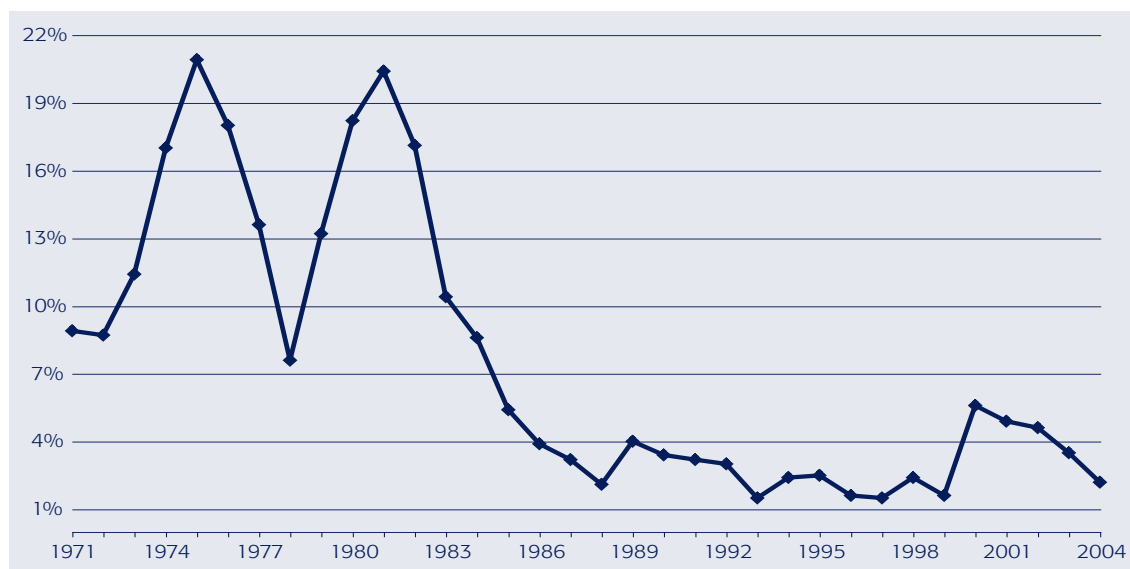
According to an OECD report (2001), it is suggested that in the UK, which has one of the most developed markets for index-linked annuities in the world, that only 10% of all annuities purchased are denominated in real terms. Irish Life also advise that the bulk of the annuity business they sell is denominated in fixed rather than real terms.

Indexation reduces the initial income stream in favour of a higher income later. As such, it is hardly surprising that members of defined contribution arrangements who are faced with a choice between an index linked pension and a level pension which has a substantially higher starting point will usually opt for the latter on the “bird in the hand” principle.

Of course in order to have a market in index-linked annuities, there must be available sufficient suitable assets to back the liabilities and this is not currently the case in relation to Irish inflation linked bonds. The availability of such bonds should lead to a more competitive market in Irish index linked annuities, and to some reduction in index linked annuity costs and might make them slightly more attractive.

The ECB has target inflation of 2% across the Eurozone. Over the last two decades, inflation has generally been single digit. The following chart shows CPI inflation over the past 30 years:

Title: Average CPI 1971-2004 (source CSO)



Benefits on Death after Retirement

Survivor's pensions are discussed below. Lump sums may also be payable on death. For example, if a pensioner or annuitant dies within the guarantee period of their pension, the balance of payments in the guarantee period may be paid as a lump sum. In the case of an ARF, the outstanding balance is transferred on death to dependants or the individual's estate.

Survivor's Pensions

Nowadays with the rise in double income families, it is likely that both partners will have an income in their own right in retirement. As such it may not be necessary to compel individuals to save for survivor's pensions. In defined benefit schemes, consideration could be given to permitting individuals to elect whether or not to pay contributions for spouse's pensions or alternatively to receive a higher personal pension. However, this could not be made retrospective as it would impose additional unfunded liabilities on schemes.

Some individuals with defined contribution provision may nevertheless wish to use part of their retirement funds to provide an income to a dependant following their death. A male aged 65 buying an inflation linked pension with a 50% dependant's pension would be able to purchase a pension of approximately 80% of the pension he would buy if he did not purchase a dependant's pension (source Irish Life annuity quotes April 2005).

Irish Life also advise that approximately two-thirds of annuities sold include provision for a spouse's pension.

Variable Pensions

A guaranteed pension removes the longevity and investment risk from the member, but because of these guarantees, the provider is required to invest primarily in fixed interest stocks, which are expected to provide lower returns over the longer term than equities. Given the life expectancy of somebody now retiring at 60 or even 65, it is reasonable to consider a pensioner as a long-term investor who may reasonably accept some investment risk to achieve a higher return. Hence a product such as a unit linked or unitised with profit pension might be attractive, where the longevity risk is underwritten by the provider but the level of pension payable each year depends to some extent on investment performance.

In summary, this can be assessed against the criteria as follows

Simplicity	These products would be more difficult to understand, as they would require the individual to understand the nature of the different underlying investments.
Flexibility	There is some flexibility for the consumer here as an alternative level of income can be chosen depending on their appetite for risk.
Value for money	There may be a perception that annuities do not provide good value for money. This may be due to a lack of understanding about life expectancy. Annuities which are backed by equity assets may be perceived to provide better value. With profit annuities may provide long-term value, although as the product may not be transparent this may not be clear to the customer.
Control over assets	If the individual could choose the investment policy, then this would give the individual more control over their retirement assets. However, once the funds were paid to the provider, the individual could not access them again.
Risk	Income is secure for the lifetime of the individual, but the level of income may vary significantly. With a with profit annuity, there will be added risk if other reserving issues arise (e.g. as in the case of Equitable Life).

ARF Option

This facility allows an individual to maintain ownership of their retirement assets while drawing down an income (taxed) to suit their needs, provided they have a separate guaranteed pension or annuity income of at least €12,700 per annum, or an AMRF set-aside, as discussed earlier.

This meets the criteria of flexibility and control over assets, and the availability of this option would seem to encourage pension provision albeit to date among the higher earners. Given that an individual must have a minimum guaranteed income for life in order to be able to avail of the option, it may also meet the need of providing adequate income or assets to meet an individual's needs during their retirement. In this context it is important that the minimum income level is maintained in real terms – both the individual's actual income and the limit required to avail of the ARF facility. It is also important that the minimum income level is sufficient to provide most or all of the basic necessities, in case the ARF is depleted rapidly.

If it is considered desirable, perhaps in the interest of equity between different classes of pension saver, to allow everybody the same facility to transfer retirement assets to an ARF, this may impact negatively on defined benefit schemes, which have been funding for the payment of retirement income rather than a lump sum at retirement. There might also be a concern that "mis-selling" of ARFs could lead to claims at a later date from pensioners whose retirement income had fallen below the level they would have received from the scheme.

In summary, this can be assessed against the criteria as follows

Simplicity	This product is relatively easy to understand, although deciding on the level of income which could be drawn may require advice.
Flexibility	These products are very flexible as the individual chooses the investment strategy and chooses how much income to draw and when to draw it. The level of income withdrawal can be varied as required. An annuity could be purchased at any time.
Value for money	Individual gets return on underlying assets.
Control over assets	The consumer has control over assets.
Risk	Income may not be available for the lifetime of the individual due to adverse investment performance or unanticipated longevity.

ARF with Restrictions

Rather than allow an individual to withdraw any amount from their ARF, limits could be imposed on maximum annual withdrawals. For example, in Chile, one of the options with the retirement fund is not to purchase an annuity, but to keep the assets within the retirement fund and make maximum withdrawals of up to the value of the fund divided by life expectancy. This amount is recalculated annually.

In the UK, there is both a minimum and maximum level of withdrawal – the minimum ensures that the individual is not excessively cautious and also enables some tax to be collected by the Revenue authorities.

There are also similar options in other countries, where variable retirement income may be drawn.

In summary, this can be assessed against the criteria as follows

Simplicity	This product is easy to understand but the minimum/ maximum rules add some further complexity.
Flexibility	There is reasonable flexibility for the consumer although there are limits on income withdrawal. An annuity could be purchased at any time.
Value for money	Individual gets return on underlying assets.
Control over assets	The consumer has control over assets.
Risk	Income may not be available for the lifetime of the individual due to adverse investment performance or unanticipated longevity, although the limits on drawdown will address some of this.

Phased Retirement

It is not possible at the moment to continue working at a reduced level and draw only partial pension (unless the individual is self employed and has a number of different policies for the provision of retirement benefits).

Given the likely future need for individuals to work for longer than in the past (in order to pay for a longer retirement than in the past), the introduction of phased retirement may be beneficial in encouraging individuals to remain in the workforce for longer. This is a wider issue than benefit options at retirement so is not considered in any further detail.

Healthcare Options

We have not investigated the possibility of providing an option at retirement for part of an individual’s pension fund to be used to purchase healthcare insurance. However, it does seem that given the increase in life expectancy, an individual’s healthcare requirements are going to increase. Advances in technology have made possible recovery from conditions that previously might have resulted in death. Care might be required for a longer period than heretofore.

It may therefore be worth considering whether there is any need for a suitable post retirement medical benefit.

Analysis Against Criteria – Summary

The above analyses are summarised in the chart below.

	Simplicity	Flexibility	Perceived Value for Money	Control	Security of Income
Cash	High	High	High	High	Low
Guaranteed Annuity	High	Low	Low	Low	High
Variable Annuity	Medium	Medium	Medium	Medium	Medium
ARF	Medium	High	High	High	Low
Restricted ARF	Medium	Medium	High	High	Medium

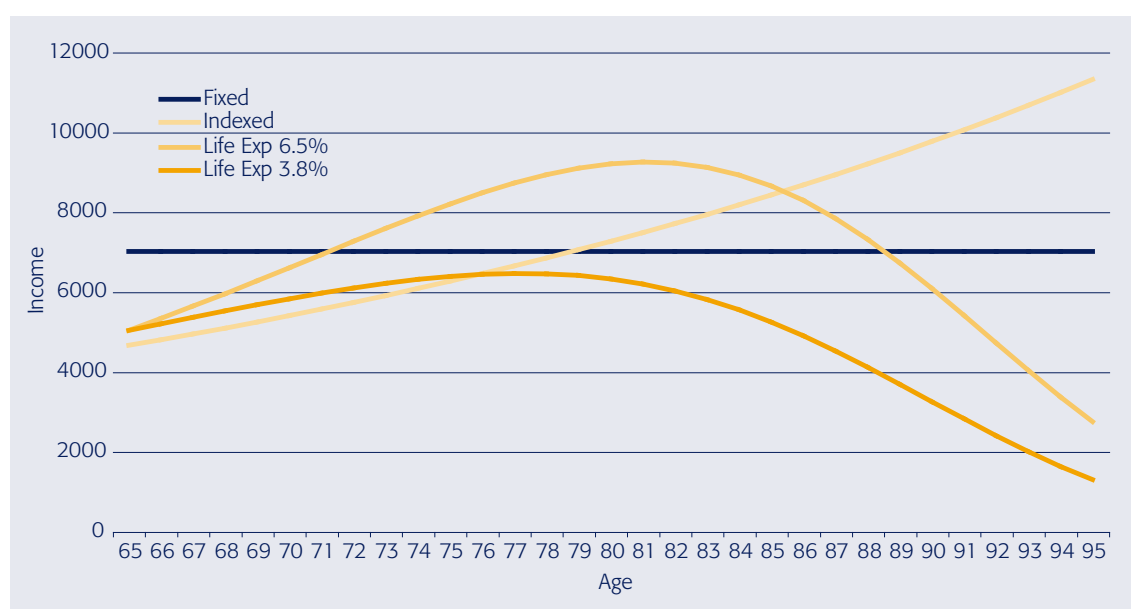
Cash flow analysis

Comparison of Income from Annuities and Controlled Drawdown

The chart below shows a comparison of income streams from 3 different sources. In all cases the individual is a male aged 65 with a retirement fund of €100,000. It is assumed that all income streams are treated in the same way for tax purposes. No spouse's pension is purchased in the annuity cases. For the indexed annuity, it is assumed that inflation linking uncapped is purchased.

The third option – a controlled drawdown option described as “Life Expectancy” – shows the income from a fund where an individual can draw income subject to a limit of fund value divided by life expectancy. This maximum amount is recalculated annually. Income streams are shown assuming a constant investment return of 6.5% per annum and 3.87% per annum. This latter rate is the return underlying the fixed annuity. The income under this option is likely to vary considerably, depending on the underlying investment return.

Title: Comparison of Retirement Income Streams Income for a male aged 65 with a fund of €100,000. Single life.



It is interesting to note that it takes about 14 years for the index linked annuity to overtake the fixed annuity. This suggests that only individuals expecting a long retirement or who anticipate high or volatile inflation would purchase an indexed annuity.

In the case of both annuities, there is no return of fund on death. Whereas for the Life Expectancy, any unused funds are returned on death.

Comparing the life expectancy 3.87% option with the fixed annuity, the benefit of cross-subsidy between annuitants is evident. Annuitants who live shorter than average contribute towards the pensions of those who live longer than average. So an individual expecting to live longer than average might choose to purchase an annuity, whereas an individual less optimistic about their lifespan might select an ARF or other phased withdrawal product.

Possible Controlled Drawdown Income Streams

The chart earlier showed the income from a controlled drawdown product where the investment return was a constant assumed rate. However, in reality, the investment return achieved would vary from year to year and as such could significantly impact on an individual's income level.

To demonstrate how the income might vary, we have carried out some projections according to two alternative investment strategies. The first is a low risk investment strategy and could perhaps include bonds as the primary asset class. The second investment strategy is referred to as a Higher Risk Investment strategy and is likely to represent investment primarily in equities.

The purpose of the exercise is not to attempt to chart the future course of investment returns, but rather to demonstrate how income might vary according to some assumed pattern of future investment returns. As such, we have adopted a rather simplistic approach to generating the returns and hence the streams of income.

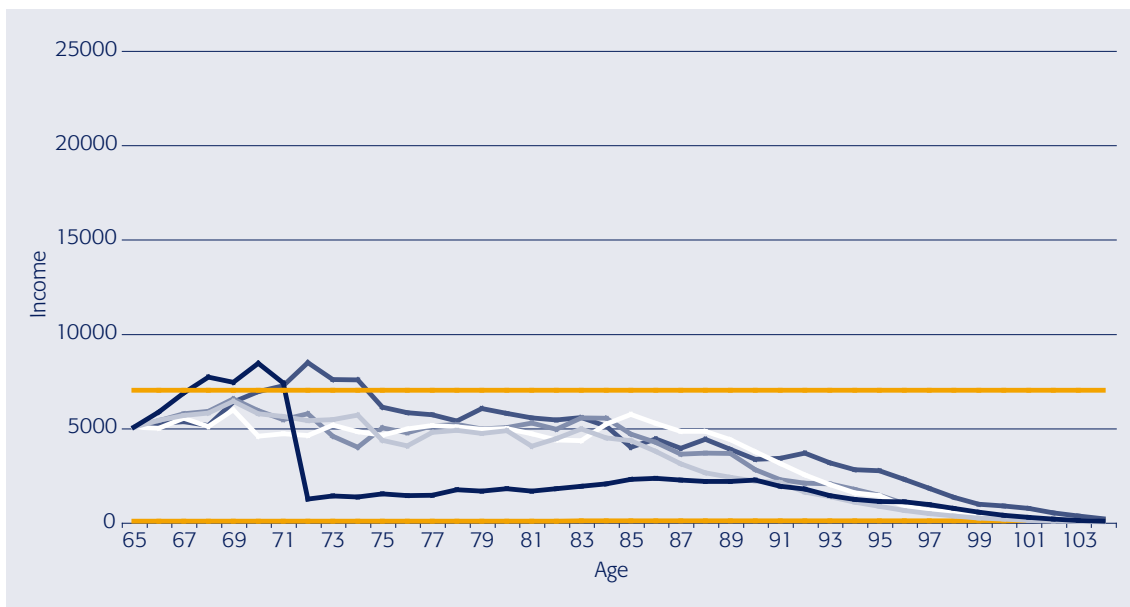
We have generated a series of random returns according to a normal distribution. The expected return on gilts was 4.75% with volatility of 7% and for equities the expected return was 7.75% and volatility 20%. We thus generated 100 series of 40 year returns. Hence, we have 100 random series of income from a drawdown type product.

All of the income streams were then sorted according to amount of income at age 80 and then the best, worst and middle 5 results were selected. These results are shown graphically. We have also included on each graph the income from a level annuity for the same purchase price and age.

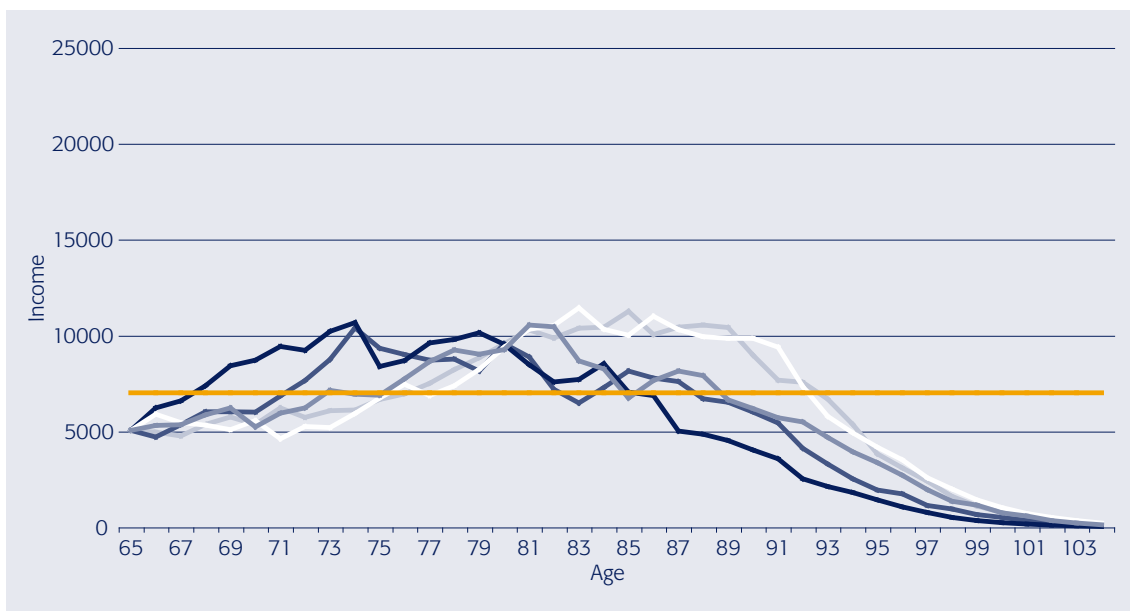
So what do the graphs show?

- The graphs show different possible streams of income from a drawdown product.
- The graphs have a hump due to the limit on drawdown of fund divided by life expectancy. As life expectancy reduces, more capital can be drawn thus running down the fund more quickly at older ages.
- One of the key differences between the annuity and drawdown is that the annuity provides insurance against the consumer outliving their funds. However, the drawdown options might be better for those who do not expect to have long retirements, as the remaining capital could be passed on to their estate.
- For someone who is risk averse (someone with low guaranteed income for example), the annuity would appear to be a better option than the low risk investment strategy drawdown product. There is a low likelihood of ever exceeding the level annuity. However, the annuity would provide longevity insurance.
- Only an individual (with dependants) who expects to live shorter than average should pursue the life expectancy low risk investment strategy over the level annuity.
- The higher risk investment strategy drawdown graphs show there is a better than evens chance of exceeding the level annuity by age 75.
- These graphs also suggest that an individual should have sufficient other guaranteed retirement income, so that they can withstand the volatility in payouts.

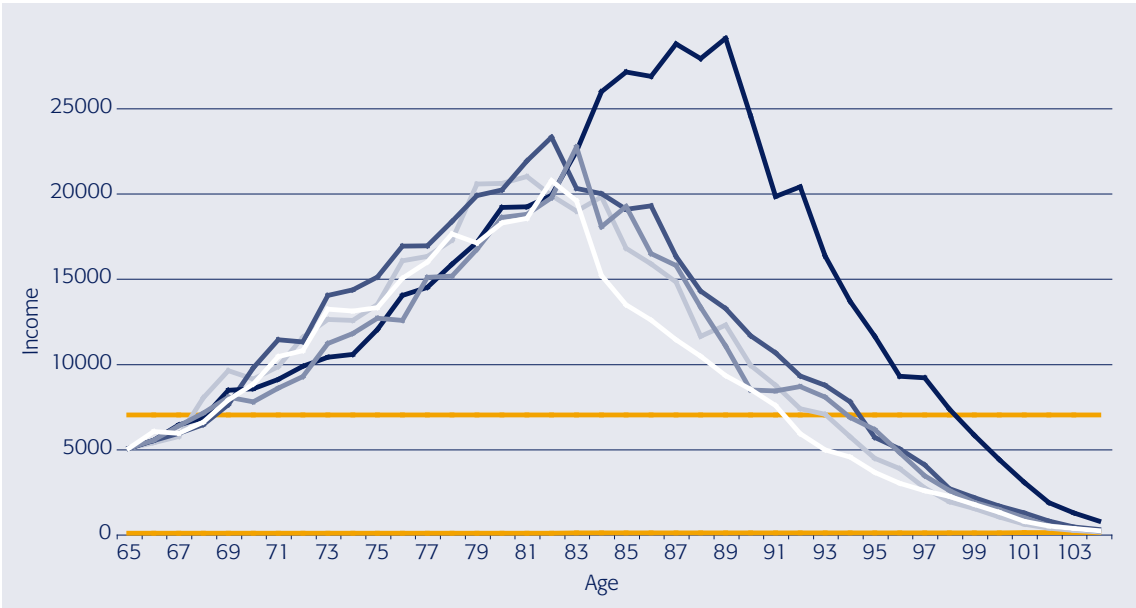
Title: Worst 5 Results Higher Risk Investment Strategy Income at age 80



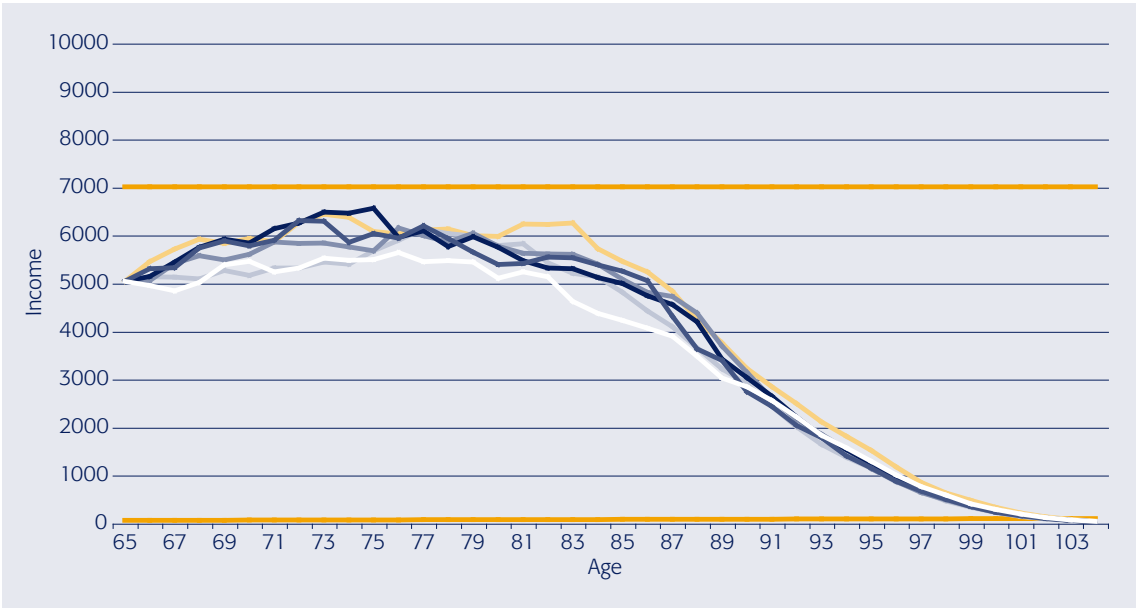
Title: Mid 5 Results Higher Risk Investment Strategy Income at age 80



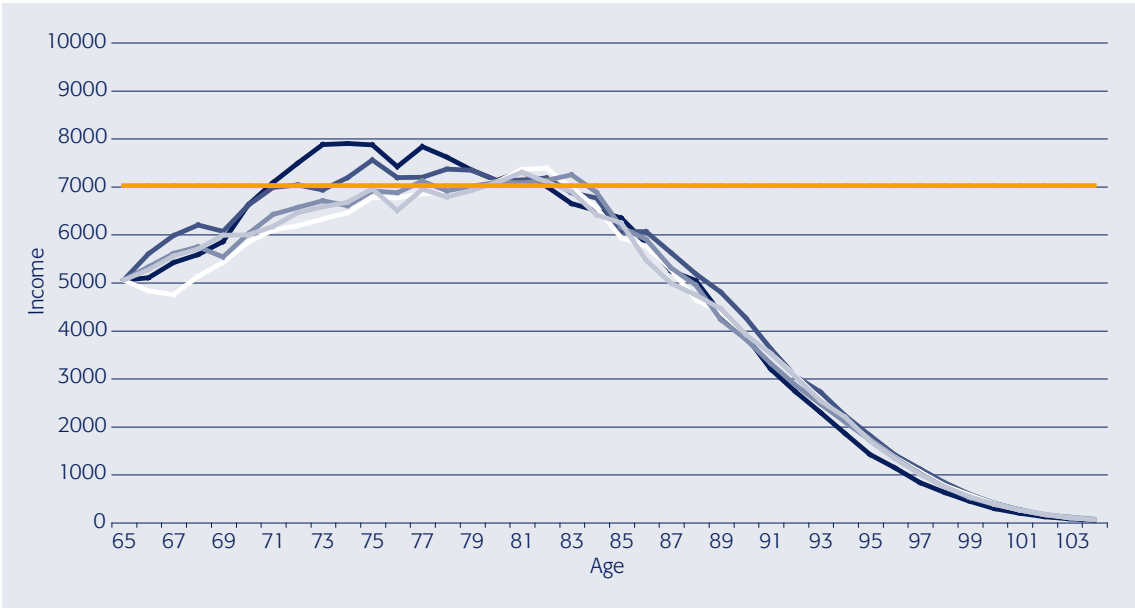
Title: Best 5 Results Higher Risk Investment Strategy Income at age 80



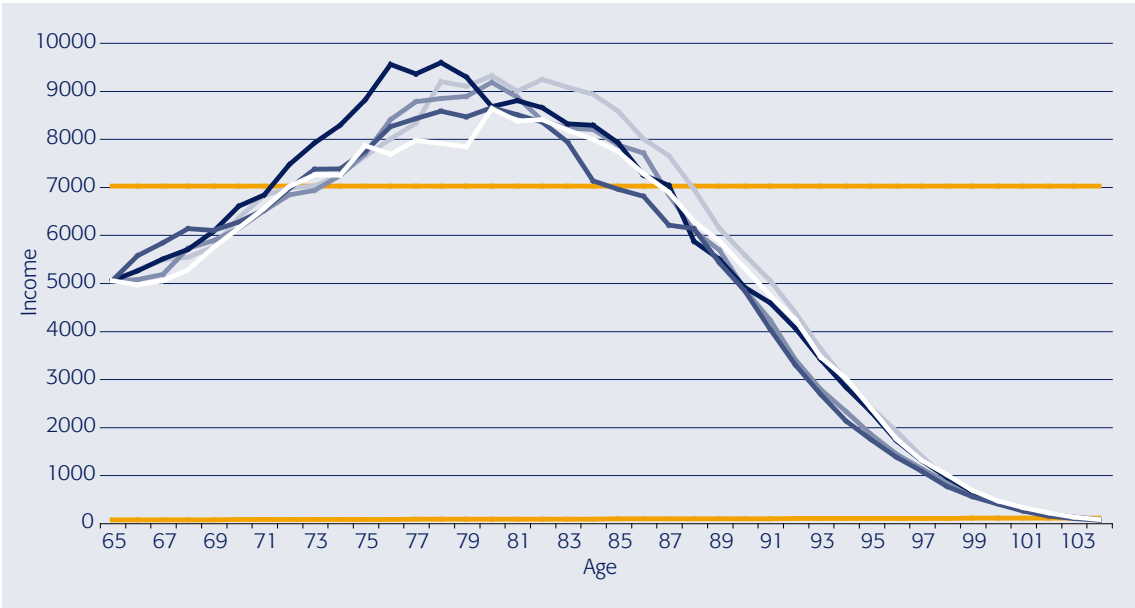
Title: Worst 5 Results Low Risk Investment Strategy Income at age 80



Title: Mid 5 Results Low Risk Investment Strategy Income at age 80



Title: Best 5 Results Low Risk Investment Strategy Income at age 80



Conclusion

Introduction

In this section, we endeavour to draw out the main issues arising from our review of the impact of benefit options at retirement on pensions coverage and the quality of pensions coverage. The conclusions reached should not be considered as a recommended approach, as there are wider issues to be considered.

Flexibility or Compulsion?

In the first place, we do not see a benefit in compulsion in relation to options at retirement. We would recommend that consumers be given a choice of options. Flexibility is important and it seems likely that there would be a positive effect on coverage and quality of coverage at ages near retirement if individuals could choose the mix of capital and income that best suited their needs, without any legislative or Revenue restrictions.

Impact of Tax Incentives

Fiscal incentives are bound to bias the options chosen and at present the ability to take tax free cash encourages individuals to select this option. It may be that this would still be the case if the tax treatment of pension and lump sum were neutral. Indeed, if considered appropriate, tax policy could be geared towards encouraging retirement assets to be converted to a stream of income. For example, annuities could be given more favourable tax treatment than benefits paid out wholly in lump sum form.

Review of ARFs

The existing options provide considerable choice for consumers at retirement, although in practice the ARF facility is available in relatively few cases. Experience to date indicates that those who have taken out ARFs have not dissipated their funds unwisely although this may reflect the nature of those who have had access to this option i.e. those with additional sources of retirement income.

Having considered the various alternative options which could be made available, it would appear that the most effective way to increase coverage would be to make ARFs

- more widely available i.e. to all members of occupational schemes in relation to all their benefits (i.e. not just AVCs) and/or
- more flexible i.e. removal of the AMRF/annuity requirement

It should first be noted that making ARFs more widely available will have no impact on the level of employee contributions to occupational pension schemes as they already have the option to make AVCs which will be ARFable. Hence this would only increase coverage if employers were to set up schemes where none currently exist, and quality of coverage would improve if employers were to increase contributions to such schemes.

If ARFs were made available to all members of DC schemes in relation to all of their benefits, this could encourage employers to set up schemes if they felt that employees would value them more if the benefits could be taken as an ARF. However, this option is already available in relation to PRSAs and the level of employer contribution to these is low.

For DB schemes, it is unlikely to be practical to make the facility to ARF benefits at retirement retrospective, as this could have serious implications for funding and investment strategy for these schemes. If introduced for future service only, employers might redesign schemes to retirement balance plans or pure DC schemes, which might not be considered desirable.

There is more likely to be an increase in coverage if ARFs are made more flexible i.e. if the AMRF/ annuity or alternative guaranteed income requirement were to be removed. This would mean that individuals would have complete control over the way in which they took their retirement income, with the only guaranteed income being the State pension. This would make the ARF option available to all, which is not currently the case, and might be expected to make retirement provision more attractive to lower earners.

If thought desirable, some level of controls could be built in e.g. a maximum level of withdrawal, or tax incentives could be given to discourage individuals from drawing down too much cash too soon. However, any such provisions would be likely to reduce the extent to which additional coverage might be achieved.

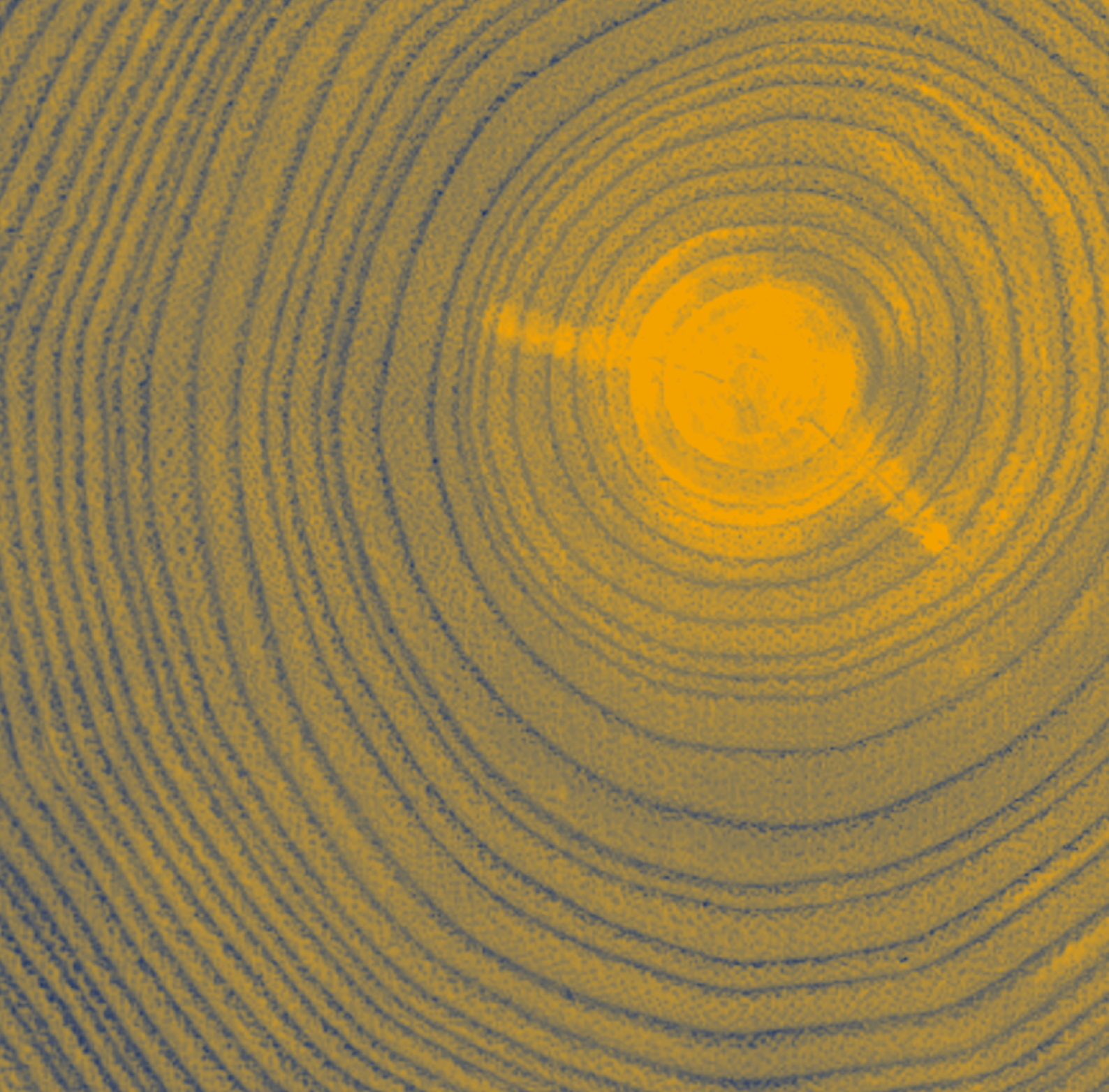
Financial Advice

In making a decision at retirement whether to take cash (taxed or tax free), annuity (level/indexed, single/joint life) or ARF, an individual needs to understand the risks associated with each option. This is likely to mean that financial advice is needed. It is not possible, assuming meaningful choice is to be provided, to make the options available sufficiently simple to ensure that they are understood by everybody. The need to take advice should not be viewed as a drawback, provided appropriate and affordable advice is widely available.

The calculations we have undertaken indicate that although theoretically appropriate, index linked annuities may not necessarily be the best choice, even if these are available on more competitive terms than at present. This is borne out by current experience, which suggests that very few index linked annuities are purchased voluntarily.

Conclusion

We look forward to discussing with you the issues raised in this report.



APPENDIX 6

LIFE STRATEGIES/ESRI REPORT ON ALTERNATIVE SYSTEMS OF PENSION PROVISION

SEPTEMBER 2005

APPENDIX 6 – LIFE STRATEGIES/ESRI REPORT ON ALTERNATIVE SYSTEMS OF PENSION PROVISION

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An assessment for the Pensions Board

Prepared by

Life Strategies Ltd.

and

The Economic and Social Research Institute

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1 Executive Summary

1.1 Background & Introduction

This report presents an assessment of certain potential alternative systems of pension provision which were put forward by the Pensions Board for detailed analysis as part of the current National Pensions Review. The report has been prepared for the Pensions Board by a consultancy team from Life Strategies and the ESRI.

1.2 Systems put forward for assessment

The key characteristics of the five alternative systems put forward for analysis by the Pensions Board may be briefly summarised as follows:

1. Enhancement of current voluntary supplementary system

- State flat-rate pension (contributory old age pension) of 34% of average industrial earnings.
- Enhancement to the voluntary supplementary pension system to allow tax credits on employee contributions at 42% (with an equivalent benefit for non-taxpayers).
- Restrictions on the maximum qualifying income and contributions for tax relief.

2. Mandatory supplementary private DC system

- State flat-rate pension (contributory old age pension) of 34% of average industrial earnings.
- A mandatory supplementary defined contribution pension system, with equal contributions from employers and employees (5% each on earnings above the PRSI minimum up to a maximum of twice average industrial earnings).
- Further voluntary employer and employee contributions are permitted and qualify for tax credits as per Alternative System 1.

3. Mandatory supplementary State-run DC system

- As Alternative System 2 but with the mandatory defined contribution scheme operated by the State rather than by private-sector institutions.

4. Mandatory supplementary State earnings-related system

- State flat-rate pension (contributory old age pension) of 34% of average industrial earnings.
- A mandatory supplementary State-run earnings related system, with equal contributions from employers and employees. The contribution rate would be set so as to be cost-neutral for the Exchequer in the long-term.
- Benefit of 1% of revalued annual pensionable earnings (defined as earnings above the PRSI minimum up to a maximum of twice average industrial earnings) for each year of contribution.
- Further voluntary employer and employee contributions are permitted and qualify for tax credits as per Alternative System 1.

5. Enhanced flat-rate pension with continued voluntary Pillar 2 provision

- State flat-rate pension (contributory old age pension) of 50% of average industrial earnings, with the additional cost of this benefit met by a separately identifiable contribution.
- Restrictions on the maximum qualifying income and contributions for tax relief.
- Otherwise no change to current system.

1.3 Financial assessment

We analysed each of the systems in terms of the projected net cost to the Exchequer (taking account of both direct and indirect costs). We also projected the expected net cost of the current system in order to provide a baseline for comparison purposes. The results of this analysis, in particular the projected movement in cost over time, provide an indication of each system's sustainability.

In our analysis we considered the following items in calculating the net cost to the Exchequer:

- The cost of Pillar 1 pensions
- Revenues from PRSI
- The cost of public service pensions
- Payments to or withdrawals from the National Pensions Reserve Fund
- The contributions and benefits under any proposed mandatory system
- The cost of tax reliefs on private-sector contributions and investment income & capital gains
- The revenue from tax on pensions in payment

The cost to the Exchequer of putting in place the administration and investment management infrastructure required to run Alternative Systems 3 and 4 has not been included in the overall cost, although this is not expected to be significant in the overall context.

The net cost to the Exchequer, taking into account all of these factors, was projected to be as follows:

Table 1.1: Projected net Exchequer cost for each system; % of GNP 2006-2056

	2006	2016	2026	2036	2046	2056
Current pension system	2.5%	4.0%	5.6%	5.9%	6.3%	7.0%
Alternative System 1	2.6%	4.2%	5.8%	6.0%	6.6%	7.2%
Alternative System 2	3.0%	4.6%	6.2%	6.5%	6.7%	7.3%
Alternative System 3	3.0%	4.6%	6.2%	6.6%	6.8%	7.4%
Alternative System 4 (funded)*	4.1%	5.3%	6.6%	6.8%	6.9%	7.3%
Alternative System 5 (funded)*	4.0%	5.6%	7.2%	7.4%	7.0%	7.1%

* 'Funded' denotes that the additional component (i.e. the mandatory earnings-related component of System 4 or the increase in the Pillar 1 benefit under System 5) is assumed to be operated on a funded (rather than PAYG) basis.

Before commenting on the results, it is important to emphasise that long-term projections are, by their nature, unlikely to be borne out in practice. We would encourage readers to focus on the trends which emerge over the period, and on the relativities between the various systems, rather than on the results for individual years.

Subject to that caveat, the first point to be made in analysing these results is that, before moving on to consider any alternative systems, it is important to realise that the net cost of pensions to the Exchequer is set to increase considerably under the current system. Our projections indicate that the net cost will almost treble from its current level of 2.5% of GNP to 7.0% of GNP by 2056.

The main driver of this increase in cost is the projected ageing of the population over the next 50 years. As Table 1.2 shows, on the basis of our central set of assumptions (which are based on the CSO's work in this area), the age structure of the population is projected to alter quite substantially over the coming years, with a substantial increase in the proportion of the population aged over 65.

Table 1.2: Population structure 2006 to 2056; central demographic scenario

Age group	2006	2016	2026	2036	2046	2056
0-14	21%	21%	18%	16%	16%	15%
15-64	68%	66%	65%	62%	57%	55%
65+	11%	13%	17%	22%	27%	29%
Total	100%	100%	100%	100%	100%	100%

One of the reasons for the increasing proportion of over-65s is that average life expectancies are projected to increase over time, as Table 1.3 shows¹.

Table 1.3: Life expectancy at 65, 2006 to 2056; central demographic scenario

	2006	2016	2026	2036	2046	2056
Male	16.0	17.6	19.2	20.6	21.3	22.0
Female	19.4	20.9	22.4	23.9	24.6	25.3

The pattern of increasing pension costs is repeated, with some variations, in each of the alternative systems. All of the systems are projected to have a net cost which is less than 0.5 percentage points higher than that of the current system in the long run. Systems 4 and 5 are projected to result in the most significant net cost increases in the short to medium term, with the additional cost declining over time.

It is important to note that, if the additional mandatory components were to be operated on a pay-as-you-go (PAYG) basis, both Systems 4 and Systems 5 would exhibit a very different progression of costs to the current system (see Table 1.4). On this basis, because of the very high levels of mandatory contributions payable, the government finances would benefit substantially in the short-term. This is an illusory benefit, however, which results from the 'cash accounting' convention. Over time, the benefit is projected to decline and will ultimately reverse as the additional mandatory pension payments exceed the mandatory contributions.

Table 1.4: Projected net Exchequer cost; % of GNP 2006-2056

	2006	2016	2026	2036	2046	2056
Current pension system	2.5%	4.0%	5.6%	5.9%	6.3%	7.0%
Alternative System 4 (PAYG)	(1.4%)	(0.3%)	1.5%	2.8%	4.7%	6.5%
Alternative System 5 (PAYG)	0.6%	2.1%	4.0%	4.9%	6.0%	7.3%

¹ Note that the projected future life expectancies quoted in Table 1.3 (and elsewhere in this report) have been calculated allowing for projected improvements in mortality until the date in question, but with no allowance for expected future mortality improvements beyond that date. This is the approach which has been adopted by the CSO (and others) when quoting projected life expectancies and we have adopted the same presentational approach for ease of comparison. This means that the quoted life expectancies do not tell the full story – on the basis of the assumed continued improvements in mortality, they understate the “true” position. It is important to note, however, that this is purely a presentational issue – all of our calculations allow fully for all projected mortality improvements.

Finally in this summary of our financial projection work, in addition to looking at each of the systems on a central set of demographic assumptions, we also re-ran the projections on two alternative demographic scenarios, the first assuming higher net immigration, the second assuming greater improvements in longevity from 2036 onwards. In summary, an assumption of higher net immigration helped considerably to defray the projected increase in costs for each of the systems (but did not completely eliminate the problem of increasing costs); an assumption of increased longevity from 2036 onwards resulted in an increase in costs in the later years of our projection relative to the results on our central assumptions. The impact of alternative demographic hypotheses was most pronounced for Alternative Systems 4 and 5 (on a PAYG basis).

Chapters 7 to 13 cover the assessment of the current system and the various alternative systems in more detail. The general methodology and assumptions employed in conducting our financial assessments are set out in detail in Chapters 5 and 6, with further system-specific assumptions set out in the relevant system assessment Chapters (7 to 13).

1.4 Qualitative assessment

As well as investigating the projected net Exchequer cost and sustainability of the various alternative systems, we were also asked to assess them against a number of criteria including:

- the economic/competitiveness/employment impacts;
- inter-generational and intra-generational equity;
- administration costs and efficiency; and,
- effect on the national savings rate.

We were also asked to comment on the relative merits of funding versus pay-as-you-go.

Economic/competitiveness/employment impacts

Each of the various alternative systems is projected to result in increased pension contributions. In modelling the economic impact of the various systems, we used the ESRI's HERMES model of the Irish economy to simulate the impact of the increased pension contributions which would be payable by employers and employees in each case. The results of the economic simulations are set out in Table 1.5.

In summary, Alternative System 2 (which involves the introduction of a mandatory defined contribution scheme) is projected to have a relatively modest impact on the economy. Alternative System 3 is identical in this regard. The impact of Alternative System 4 is more pronounced, however, reflecting the very substantial contributions required to fund the proposed earnings-related pension. (We calculated the required contribution rate as 26.5%, payable on all earnings above the employee PRSI threshold up to the level of twice gross average industrial earnings). The impact of Alternative System 5 is projected to be greater than that of Alternative System 2 but less than that of Alternative System 4.

Table 1.5: Economic impacts (in fifth year following introduction) of introducing alternative systems, % change compared to base

	Alternative Systems 2/3	Alternative System 4	Alternative System 5
GNP	-0.1	-0.7	-0.4
Employment	-0.3	-1.5	-0.9
Unemployment Rate	+0.1	+0.7	+0.4
Consumer Prices	-0.2	-1.2	-0.7
Wages	+0.3	+1.7	+1.1
Real Personal Disposable Income	-0.4	-2.0	-1.2

Notes:

1. There are no figures for Alternative System 1, as the system is essentially a continuation of the current system and does not introduce any mandatory pension contributions.
2. The figures for Alternative Systems 2 and 3 are identical as the level of mandatory contributions is the same for both systems.
3. The figures in the table for the effect on the unemployment rate are quoted in percentage point terms.

Inter-generational equity

Under the current system, inter-generational equity is only really an issue for Pillar 1 and public service Pillar 2 pensions (both of which are on a pay-as-you-go basis). All private sector Pillar 2 arrangements are managed on a funded basis. The issue, therefore, revolves around the question of whether or not to fund the pay-as-you-go elements – moving to a funded system would involve the current generation of workers paying for both their own pensions and those of the current pensioners. Alternative Systems 1 to 3 introduce no new issues in this regard.

For Alternative Systems 4 and 5, assuming that the new/additional State pension is operated on a funded basis, the issues are again as for the current system. If the new component were to be operated on a pay-as-you-go basis, the discussion would then revolve around the pros and cons of funding (see below). However, it is important to note that introducing additional Pillar 1 benefits on a pay-as-you-go basis would only serve to exacerbate (and defer) the future funding problems.

Intra-generational equity

The current Pillar 1 system is redistributive in nature – lower earners do proportionately better than higher earners in terms of benefits received versus contributions paid. For the current Pillar 2 system, the main issue under this heading relates to the unevenness of Pillar 2 pension coverage and hence the uneven distribution of tax benefits. The current tax treatment of Pillar 2 pensions could be criticised as inequitable, as high earners receive disproportionate tax benefits. The two main reasons for this are that Pillar 2 coverage increases strongly with income and that the tax relief is given at the marginal rate of tax.

With regard to Alternative Systems 1 to 4, the proposed changes to the rules for tax relief on contributions (i.e. providing relief at the same rate for all and capping the amount of relief available to high earners) would be expected to address this criticism of the current system.

The mandatory defined contribution elements of Alternative Systems 2 to 4 do not have any redistributive effect and, as those earning less than the PRSI threshold are not covered, they do nothing to improve the position of the lowest earners. They do, however, improve the likely replacement ratios of middle-income earners without occupational or personal provision.

Alternative System 5, which involves increasing the level of the State Pillar 1 benefit, helps to address some of the criticisms which are sometimes levelled at the current system i.e. that the Exchequer support for voluntary Pillar 2 provision is regressive and that it would be more equitable to direct State resources towards providing a higher level of Pillar 1 benefit.

Table 1.6 summarises the projected replacement rates (i.e. projected retirement income as a percentage of pre-retirement earnings, allowing for both Pillar 1 and mandatory Pillar 2 benefits) for those alternative systems which involve the introduction of a mandatory component or, in the case of System 5, an enhancement to the Pillar 1 benefit.

Table 1.6: Projected replacement rates under various alternative systems

	Earnings level (as % of Gross Average Industrial Earnings)			
	0.5 x GAIE	1.0 x GAIE	2.0 x GAIE	3.0 x GAIE
Alternative System 2	68%	42%	29%	19%
Alternative System 3	68%	43%	31%	20%
Alternative System 4	68%	55%	47%	32%
Alternative System 5	100%	50%	25%	17%

The contents of this table need to be treated with some care (several caveats apply; the reader is directed to 14.10 for details). We can say, however, that Alternative System 4 can be expected to deliver the highest replacement rates for those earning at least the gross average industrial wage; lower earners do best with Alternative System 5.

Administration costs and efficiency

It is difficult to draw any meaningful conclusions about the relative efficiency of the various components of the current pension system. It appears, however, that private sector occupational and personal plans are somewhat more expensive than is the case in the UK (which is the most relevant country for international comparisons), possibly reflecting the more limited economies of scale which are available in the Irish market.

Given the mandatory nature of Alternative System 2, the market for pensions in Ireland would expand to approximately 1.4 million people (i.e. those in the labour force earning more than the PRSI threshold) which should allow the largest pension providers to price their products more keenly than at present. One could then allow market forces to dictate the level of charges for mandatory pensions or one could decide to impose a price cap (as is currently the case with Standard PRSAs).

Lower costs ought to be attainable under Alternative System 3, given the potential savings from having a simple single-provider system, general economies of scale, the State's purchasing power and the absence of a profit margin. It should be noted that this assumption does not constitute a judgement on our part about the relative efficiencies of the public and private sectors: we are simply pointing out that a system with the characteristics of Alternative System 3 should, in theory, be simpler and cheaper to run than one with the characteristics of Alternative System 2. In this regard, it is important to bear in mind that there are many possible approaches to operating Alternative System 3, ranging from full State control (whereby the State collects the contributions, pays benefits, keeps the necessary records and also manages the investments) to a fully outsourced model where all of these functions are carried out by private-sector contractors.

The issues for Alternative System 4 are quite similar to those for System 3, although in the case of this system there is no requirement to provide members with investment options. It is open to debate as to whether a defined contribution (System 3) or an earnings-related system (System 4) is more complex from an administrative and record-keeping perspective.

Under Alternative System 5, the only change is an increase to the level of the Pillar 1 benefit. There are no particular administrative impacts, therefore. Accordingly, the level of administration costs and relative efficiency of this system should be as for the current system.

Finally, under each of Systems 3 to 5, it is possible that the increase in the level of State provision could lead to a substantial reduction in demand for Pillar 2 pensions. In theory, this could have an impact on the cost of Pillar 2 pensions.

Effect on national savings rate

Predictions on the impact of alternative pension systems on national savings are difficult to make. In sections 10.10 and 13.10 we set out the issues involved and tentatively suggest that System 5 is more likely to lower household saving and Systems 2 to 4 are more likely to raise household saving.

Relative merits of funding versus pay-as-you-go

A key decision in designing a pension system is whether to rely on an unfunded pay-as-you-go (PAYG) system or to fund pensions by investing the contribution income received. There are important differences between these two approaches, but both involve a transfer of resources from the working population to pensioners and both are affected by demographic changes (although not identically). The economic theory of funding versus PAYG is quite involved² and its relevance to the assignment in hand is questionable.

Rather, it seems to us that the main advantages of a funded system over a PAYG system relate more to questions of financial discipline and transparency:

- the exercise of funding (unlike PAYG) quantifies future liabilities;
- the true cost of any changes to pension terms is quantified and is immediately apparent under a funded system (unlike under a PAYG system where the immediate cashflow cost may be negligible); and,
- funding can help to smooth the cost of pensions over time.

The big disadvantage of PAYG in an ageing population is the implicit need to raise contributions if benefit levels are to be maintained. If one were introducing a pension system from scratch and knew that the population was ageing one would probably opt for a funded approach.

A difficulty arises when, as with the current Irish system, you already have a PAYG system and you want to consider moving to a funded model. In this situation current employees are essentially being asked to pay twice – to fund their own pensions and to pay the pensions of today's retirees. Hence the big disadvantage of a move from PAYG to funded is the intergenerational equity issue.

Some of the other arguments about the relative merits of funding versus PAYG relate to the potential impact on national savings. It might be argued that a funded system raises savings and hence investment. If this raises the productive capacity of the economy, then perhaps funding is preferable. However, as we comment later in this report, it is not axiomatic that funding leads to increased saving.

² See Appendix B of The Pensions Commission (UK) (2004), *Pensions: Challenges and Choices* for a detailed treatise on PAYG versus funding.

1.5 Summary

1.5.1 Current system

Before examining the five alternative systems put forward by the Pensions Board, we first examined the current system in terms of the projected net Exchequer costs. Our calculations indicate that the overall net cost to the Exchequer of the current system is projected to increase almost threefold over the period to 2056, from 2.5% to 7.0% of GNP. These projections were carried out on the assumption that the current system would continue as at present – we assumed, for example, that Pillar 2 coverage rates would remain at their current levels (roughly 53%).

The detailed projections are set out in Chapter 7, but in summary, the main driver of this overall increase is the projected increase in the cost of Pillar 1 and public service pensions. The combined gross expenditure on these items is projected to increase from 4.3% of GNP to 13.8% of GNP over the period in question; the combined income from the National Pensions Reserve Fund, PRSI revenues and tax on public service pensions is projected to be 8.0% in 2056, leaving a net cost of 5.8% of GNP in 2056. The net cost of private sector Pillar 2 pensions (i.e. tax reliefs on contributions and investment returns, less tax revenues from pensions in payment) is projected to return to its current level of 1.2% of GNP in 2056 (having first increased slightly in the intervening period). Combining these gives a total net Exchequer cost of 7.0% of GNP in 2056.

The results were also examined on two alternative demographic scenarios – higher immigration and increased longevity post-2036. The latter had a small impact in the years after 2036, whereas the former had a larger impact, with a projected net cost in 2056 of 5.7% rather than 7.0% of GNP.

1.5.2 Alternative System 1

As outlined in section 1.2 above, Alternative System 1 is essentially a continuation of the current system, with some amendments to the tax regime for Pillar 2 pensions: employee contributions would now qualify for tax credits at 42% (with an equivalent benefit for non-taxpayers) and there would be restrictions on the maximum qualifying income and contributions for tax relief.

As this system involves relatively minor changes to the current system, the projected Exchequer costs are quite similar. Because we have assumed some increases in coverage at lower income levels (because of the more generous tax treatment), the annual net Exchequer cost is projected to increase slightly (by about 0.2% of GNP). In practice, it is debatable whether increased tax incentives for lower earners will have any impact on coverage levels.

It should be noted that our financial projections made no allowance for the potential savings to the Exchequer from the proposed curbs on tax relief for high earners (as they are likely to be relatively small). Our projections may slightly overstate the additional cost of this system, therefore.

1.5.3 Alternative System 2

Alternative System 2 would see the introduction of a mandatory supplementary defined contribution pension system, with equal contributions from employers and employees (5% each on earnings above the PRSI minimum up to a maximum of twice average industrial earnings). Further voluntary employer and employee contributions would be permitted and would qualify for tax credits at 42% (with an equivalent benefit for non-taxpayers) but with restrictions on the maximum qualifying income and contributions for tax relief.

In projecting the future cost of this system we assumed that, following the introduction of the mandatory system, there would be no new entrants to the existing voluntary Pillar 2 arrangements other than people earning more than approximately 1.7 times the average industrial wage. Accordingly, under this system (as well as Systems 3 & 4) pension coverage is projected to start at close to 80% of the over-30 workforce, falling to close to 70% over time as voluntary provision amongst lower income earners declines. In terms of the impact on existing Pillar 2 members, we assumed that voluntary contributions would fall so that the total contribution (voluntary plus mandatory) would remain unchanged.

On this basis, we project a somewhat higher net Exchequer cost than under the current system (approximately 0.5% of GNP annually) because of the higher cost of tax relief with the introduction of mandatory contributions and the cost of paying mandatory employer contributions for public servants. Over time, however, this extra cost falls as the membership of voluntary schemes declines. From an economic perspective, our models indicate that the introduction of this system would have a relatively modest impact.

The main advantage of this system (as with any mandatory system) is that it automatically provides universal coverage. However, there is the possibility that for many people the mandatory pension becomes their only Pillar 2 provision, which leads to potential adequacy issues. (Our calculations indicate that, for someone with a full contribution history, the mandatory system can be expected to provide a pension of approximately 10% of gross average industrial earnings at retirement).

Of course, any mandatory system is open to criticism on the grounds that compulsion may be undesirable and unpopular. It seems fair to assume that some will seek to characterise the mandatory contributions as a 'stealth tax' and that a proportion of the public will view them in this way. This is true of any mandatory system. However, introducing a mandatory system run by private sector financial institutions has the potential to bring further politically-motivated accusations. In addition, there appears to be a widely-held distrust of financial institutions amongst the general public and a scepticism about the benefits of conventional pension plans, which would need to be addressed.

As with any defined contribution system, the mandatory component of Alternative System 2 brings the risk that members may suffer losses as a result of poor investment returns. The acceptability of this, especially given the compulsory nature of the system, needs to be carefully considered. A private-sector system also brings the additional risk that a financial institution may itself run into financial difficulties at some point in the future, with potentially negative consequences for those whose pensions are invested with it.

Finally, there will be practical difficulties in integrating the system with the existing Pillar 2 system, especially in relation to public service pension arrangements. (This comment is not confined to this system but is true of any mandatory system which is introduced into an environment where there is a pre-existing voluntary Pillar 2 system.)

1.5.4 Alternative System 3

This system would be identical to Alternative System 2 in all regards, except that the mandatory defined contribution scheme would be operated by the State rather than by private-sector institutions.

Accordingly, the projected coverage, contributions and net Exchequer costs are very similar to those of System 2. The cost to the Exchequer can be expected to be slightly higher under this system, however, due to the increased amount of tax foregone³ on investment income (on the assumption that this system would have lower operating expenses than System 2) and the direct operating costs themselves.

³ It is open to question whether the 'tax foregone' on the investment income arising from assets which have been accumulated as the result of a mandatory system is really a cost to the Exchequer. For comparability with the current system, we have included it as a cost in Alternative Systems 2 and 3.

Our qualitative comments on this system are essentially as for System 2 (i.e. the same general comments on mandatory systems apply). It is arguable, however, that the question of providing investment performance guarantees becomes more of an issue in a State-run system. However, if the need for guarantees is accepted, this begs the question as to why one would establish a defined contribution system – why not establish a defined benefit system instead?

On the other hand, a State defined contribution system does have some design advantages over a State defined benefit system, notably that it would be easier to adjust the system to allow for increasing longevity (as the annuity rate at retirement age could be adjusted from time to time in the light of improvements in life expectancy). It would also allow flexibility with regard to the retirement age – the annuity rate would reflect the age at which the pension is taken.

Our other comments on this system relate to the consideration of the pros and cons of State-run versus a privately-run defined contribution system. These revolve around issues such as choice, trust and charges. The implications for private-sector pension providers of introducing a mandatory State-run system would also need to be considered.

1.5.5 Alternative System 4

As outlined in section 1.2 above, Alternative System 4 would see the introduction of a mandatory supplementary State-run earnings related system, with equal contributions from employers and employees on the basis of a contribution rate which would be set so as to be cost-neutral for the Exchequer in the long-term. The system would deliver a benefit of 1% of revalued annual pensionable earnings (defined as earnings above the PRSI minimum up to a maximum of twice average industrial earnings) for each year of contribution. Further voluntary Pillar 2 provision would be permitted and would qualify for tax credits as outlined for Alternative Systems 1 to 3.

We calculated that, in order to meet the cost of the benefits under this system, a new entrant should pay 26.5% of his or her pensionable earnings (as defined above). This new entrant rate, which was calculated allowing for future mortality improvements, was taken as the contribution rate required to make the system cost-neutral in the long-term.

Contributions at this level are likely to be politically unacceptable, rendering this system unworkable in its current form. Furthermore, our models indicate that introducing a system with such high contributions would have a substantial impact on economic growth and employment. A similar system with more modest benefits might be more acceptable, however.

In projecting the future cost of this system, we made similar assumptions to those outlined in 1.5.3 above in relation to the impact on existing Pillar 2 membership and contributions. Our projections indicated that this system would result in an immediate increase in the net Exchequer cost (if the mandatory component is operated on a funded basis). The additional net Exchequer cost is projected to start at 1.6% of GNP, falling to 0.3% by 2056.

On a PAYG basis, however, System 4 would exhibit a very different progression of costs compared to the other systems examined above: the net Exchequer cost is calculated to rise from -1.4% of GNP to +6.5% of GNP in 2056. In other words, the system would be revenue-positive in the early years, with the cost gradually increasing to end up close to the projected cost of the current system by 2056.

These apparent cost savings are illusory, however (as can be seen from the projected position if the mandatory component is assumed to be operated on a funded basis). Indeed, introducing a State-run earnings-related system and running it on a pay-as-you-go basis would simply create a bigger future funding problem, albeit a problem that was substantially deferred to beyond 2056.

As is the case with Systems 2 and 3, the mandatory component of this system has no redistributive effect – benefits are determined based on earnings, and those earning less than the employee PRSI threshold are excluded.

Finally, as a system with a State-run mandatory component, many of the comments made in the section on Alternative System 3 above on the merits or otherwise of State-run mandatory systems apply equally to this system. The main difference between this system and System 3 is that one is a defined benefit system whilst the other is defined contribution. In comparing Systems 3 and 4, therefore, the choice boils down to a low contribution DC option or a high contribution DB option.

1.5.6 Alternative System 5

Under this system, the Pillar 1 flat-rate pension (contributory old age pension) would be immediately increased to 50% of average industrial earnings, with the additional cost of providing this benefit met by a separately identifiable contribution. In relation to the Pillar 2 system, there would be no change from the current system other than the introduction of restrictions on the maximum contributions for tax relief purposes.

We calculated that an additional contribution of 9.2%, payable on all earnings, would be required to fund this increase in the Pillar 1 benefit. In common with all other systems, the contribution was assumed to qualify for tax relief (in this case, at the contributor's marginal tax rate) as well as PRSI relief. In looking at the economic impact of levying this additional contribution, we found that just as the total contribution amount lies between those of Systems 2 and 3, so to do the simulated impacts on economic growth and employment.

In modelling this system, we made similar coverage and contribution assumptions for the existing voluntary Pillar 2 arrangements as for Systems 2 to 4 (i.e. we assumed that only high earners would join voluntary schemes in the future and we adjusted voluntary contributions to take account of the mandatory contributions payable). We assumed that the additional Pillar 1 pension (i.e. the extra amount resulting from the increase from 34% to 50%) would be taxed at 20%. In contrast to Systems 2 to 4, our treatment of public service workers assumed that the additional 'mandatory pension' (in this case the increase in the Pillar 1 pension) would only be payable to those who were integrated with the social insurance system.

The resulting pattern of projected net Exchequer costs for this system shows a similar progression to that of System 4 – the cost in the early years (assuming a funded approach to the additional Pillar 1 benefit) is greater than the cost of the current system (and greater than System 4), with the additional cost reducing over time.

The progression of costs on a PAYG basis is also similar to that of System 4.

As with System 4, however, the apparent PAYG benefits are illusory. Indeed, increasing the size of the Pillar 1 pension and running it on a pay-as-you-go basis would simply create a bigger future problem of rising costs than is currently the case (although, as with System 4, this problem would not become apparent for some time). However, given that moving to a funded system involves the current generation of workers paying 'on the double', increasing the size of the Pillar 1 pension adds to the potential for inter-generational inequity in this regard.

In commenting on the characteristics of this system, the first point which needs to be made is that it is probably the most simple, most easily understood and most easily administered of Systems 2 to 5. It is also the only one with a redistributive dimension, and is the only one of the five alternative systems which benefits the current generation of pensioners. There are, however, some practical issues around integration with existing Pillar 2 schemes which would need to be worked out.

2 Introduction & background

2.1 Introduction

This report presents an assessment of certain potential alternative systems of pension provision which were selected for detailed analysis by the Pensions Board. It was prepared by Life Strategies Limited (“Life Strategies”) and the Economic and Social Research Institute (“ESRI”) for the Pensions Board.

2.2 Background to the report

At the request of the Minister for Social and Family Affairs, the Pensions Board is preparing a report on the extent of coverage of the population by Second Pillar Provision and on associated issues.

As part of this review (termed the “National Pensions Review” or “NPR”), the Pensions Board is examining a number of different pension provision systems. Part of the assessment of these systems comprises an examination of the cost and sustainability of each system, including the fiscal and economic impact, and a comparison with the current Irish pensions system.

A range of pension systems has been selected by the Pensions Board for examination, some of which include changes to the current voluntary system and/or the introduction of mandatory systems.

Following a tender process, the Pensions Board requested Life Strategies and the ESRI to prepare an assessment of each of its selected systems. This assessment includes both quantitative and qualitative elements and involves a comparison against the base line of a projection of the current Irish pensions system. We have not been asked to come to any conclusions about which system is “best”, nor have we been asked to recommend one system over another.

2.3 Scope of our work

The scope of our work was defined in the initial tender document issued by the Pensions Board in March 2005. The key elements of our work were items 3-9 of the requirements as outlined in that document. These are reproduced here for convenience:

3. The Board requires the preparation of an assessment of each of the systems under consideration. This assessment should include a quantitative assessment as detailed in 4. below, and a qualitative assessment as described in 6. The base line will be a projection of the existing First and Second Pillar arrangements.
4. The Board will require a financial projection of each system to provide estimates of savings flows and benefit payments by reference to projected GNP. This should include an estimate of the effect on taxation and Government financing. The purpose of this projection is to provide information to aid assessment of the relative merits and sustainability of alternative pension systems.
5. The projection should be based on demographic projections that are as up to date as possible, though the use of a range of such assumptions would be useful. It should incorporate a range of financial and economic assumptions, though a central or preferred set of assumptions would be required. Consistency with official projections would be desirable. The demographic assumptions would need, in particular, to align with those to be used by the Department to estimate First Pillar liabilities at 8.

6. In addition to the quantitative projections, the Board will require an assessment (both qualitative and as far as possible quantitative) of each of the systems being projected. This assessment would include:
 - sustainability
 - direct and indirect Exchequer costs
 - economic/competitive/employment impacts
 - inter-generational equity
 - intra-generational (re)distributive effects
 - likely administration costs and efficiency in comparison with the current pension arrangements and in comparison with other systems
 - the relative merits of funding versus pay as you go; and
 - effect on the national savings rate.
7. Inherent in consideration of the system at 2(iii) would be an assessment of the relative merits of State support via continued tax expenditure to the Second Pillar vis-à-vis cash expenditure of equivalent amount under an enhanced First Pillar.
8. As the Department of Social and Family Affairs will be preparing an updated estimate of First Pillar liabilities, the assignment will include liaison with that Department in this respect including in relation to updating of estimated PRSI receipts which will form part of the assignment.
9. As the Department of Finance will be preparing an updated estimate of the costs of public service pensions and in consultation with the National Treasury Management Agency, will prepare any relevant material in relation to National Pensions Reserve Fund, the assignment includes coordination with that Department on these matters.

2.4 People involved and further contact

This report has been prepared by Michael Culligan, Dermot Corry and Andrew Kay from Life Strategies and by Alan Barrett and Adele Bergin from the ERSI. Queries should be addressed initially to

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2.5 Acknowledgements

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2.6 Structure of the report

The remainder of this report is structured as follows:

- Chapter 3 briefly summarises the main features and characteristics of the current Irish pension system.
- In Chapter 4 we describe the five alternative systems which we have been asked to assess.
- Chapter 5 provides a high-level outline of the methodology and assumptions we employed in conducting our assessments.
- Chapter 6 outlines the demographic and economic projections which we carried out and which form the basis for much of our financial modelling in later chapters.
- In Chapter 7 we set out our financial assessment of the current pension system. As well as providing the results of this assessment, this chapter also includes considerable further detail on the methodology and assumptions employed.
- Chapter 8 contains a critique of the current system against a number of other headings.
- Chapters 9 to 13 contain the details of our assessment of the five alternative systems.
- We summarise our findings in Chapter 14.

3 The current Irish pension system

3.1 Introduction

We were asked to assess five potential alternative systems of pension provision and to compare them with the current Irish pension system. In Chapter 4 we describe each of the five alternative systems in turn. Firstly, however, in this chapter we summarise the main features of the current Irish pension system.

3.2 Outline of current system

The current Irish pension system can be characterised as consisting of three tiers or pillars, plus a social welfare safety net.

3.2.1 Pillar 1

The first pillar is the public mandatory social insurance (PRSI) system which insures all workers against the risks of loss of income (whether by unemployment, ill health etc. as well as by old age). It is a pay-as-you-go (PAYG) social insurance scheme that is financed by contributions from employees, employers, the self-employed and by a contribution from the Exchequer when the cost of the benefits exceeds the contribution income.

PRSI contributions are paid into the Social Insurance Fund. This fund helps to pay for the Retirement Pension scheme and the Old Age Contributory Pension (OACP) scheme. The pensions payable under both of these schemes are identical flat-rate pensions. The Retirement Pension is payable at age 65 to those who retire from insurable employment and who satisfy the social insurance contribution conditions. The OACP is payable at age 66 to those who satisfy the social insurance contribution conditions.

The OACP (for a person aged 66 to 80 with a full contribution history) is currently €179.30 per week. This equates to approximately 31% of gross average industrial earnings⁴.

3.2.2 Pillar 2

The second pillar is the voluntary private pension system which currently covers just over half of those in employment. Favourable tax arrangements have been made for private pension saving to encourage the growth of the private pension system. Under these arrangements, tax reliefs are given on employer and employee pension contributions, on the investment income and capital gains of the pension funds, and on a lump sum which may be taken at retirement. Pensions in payment are taxed as income in the hands of the recipient.

Occupational schemes

The private pension system consists of occupational and personal pension schemes. Occupational pensions are provided on a voluntary basis by employers for their employees and are funded by contributions from both employers and employees or (more rarely) by the employer alone.

Until relatively recently the most common type of occupational scheme was a defined benefit (DB) scheme, but this has changed in recent years with a steady shift towards defined contribution (DC) schemes.

Defined benefit schemes are intended to provide an earnings-related supplement to the flat-rate State pension, so that the combined income from both sources will enable members of defined benefit schemes to maintain their living standards in retirement. In a defined benefit scheme the employer undertakes to provide a pension that will replace a specified proportion of the employee's earnings (normally 2/3rds of pensionable earnings at retirement for employees

⁴ It should be noted that, as instructed, we have projected the costs of the current system and of Alternative Systems 1 to 4 on the basis that this benefit rises to 34% of the previous year's gross average industrial earnings with immediate effect.

with full service). If the defined benefit fund is not sufficient to cover the promised benefits, the employer is normally responsible for making up the shortfall (if the pension promise is to be honoured). Hence, in a defined benefit scheme it is normally the employer who is exposed to the risk of increasing pension costs (whether due to poor investment performance, higher than anticipated earnings inflation, or greater than expected longevity).

In a defined contribution arrangement, a specified proportion of earnings is contributed to the pension fund by the employer and the employee or (more rarely) by the employer alone. The accumulated value of the pension fund is ultimately used to buy an annuity to provide an income during retirement. The amount of the pension will thus depend on the value of the accumulated fund at retirement and on the price of annuities at that time (which in turn depend on prevailing interest rates and longevity assumptions). The important point is that, in a defined contribution arrangement, it is the employee who is exposed to the risk that his pension fund may perform poorly (and/or that annuities will become more expensive).

Both types of scheme, DB and DC, allow individual employees to make additional voluntary contributions (AVCs) over and above the normal contribution rate.

Personal pensions

Personal pension plans are another type of Pillar 2 pension arrangement. These include what are known as Retirement Annuity Contracts (RACs) which may be taken out by the self-employed or by those whose employer does not provide an occupational scheme. Since 2003 individuals have also been able to contribute to Personal Retirement Savings Accounts (PRSAs). Participation in a PRSA scheme is voluntary for employees, though employers who do not already operate a pension scheme are required to put in place arrangements so that their employees can access a PRSA if they wish.

Both RACs and PRSAs operate like defined contribution pension schemes, with the benefits ultimately determined by the size of the accumulated pension fund and with the individual exposed to the risk of poor investment performance and/or increases in the price of annuities.

3.2.3 Pillar 3

The third pillar consists of voluntary non-pension sources of retirement income. It includes private savings, earnings from work, investment income and income provided from other sources.

It is fair to say that this pillar is growing in importance (although it is difficult to source hard and reliable data on this) and cannot be ignored in considering future pension policy, particularly given the increasing propensity for many individuals to view an investment property as an important part of their pension planning.

However, consideration of Pillar 3 issues is outside the scope of our assignment and they are not considered further in this report.

3.2.4 Social welfare safety net

The final component of the current Irish pension system is the social welfare safety net. This consists of the Old Age Non-Contributory Pension for the elderly and the Widow(er)'s Non-Contributory Pension. These schemes, which are means-tested, provide flat-rate pensions for the low-income elderly and for low-income widows and widowers.

Finally, both contributory and non-contributory pensioners receive certain benefits-in-kind, such as free travel on public transport, free electricity, free telephone line rental and, above age 70, free medical cards.

Taken together, the pension benefits and the benefits-in-kind are intended to prevent older people from falling into poverty during retirement.

3.3 Extent of current pension coverage

State encouragement of voluntary occupational and private provision by means of favourable tax treatment has resulted in just over half of the workforce having such cover. According to the most recent CSO survey⁵ of pension coverage, 52.4% of the workforce have some form of Pillar 2 pension arrangement. Figures in the most recent annual report⁶ from the Pensions Board put the total number of active members of occupational schemes at some 726,000 (these figures do not include those with personal pension arrangements).

In its National Pension Policy Initiative report⁷ the Pensions Board set a pension coverage target of 70% of those aged over 30. Personal Retirement Savings Accounts (PRSAs), recommended by the Board, were introduced from early 2003 with the aim of significantly increasing supplementary coverage and reaching this goal.

3.4 Public and private sectors – similarities and differences

It is important to recognise that, although there are certain similarities between the systems of pension provision for public and private sector workers, there are some important differences.

Coverage

Almost all public servants are covered by defined benefit schemes. Although there are many different occupational schemes in the public service with a wide range of different terms, it is fair to say that, generally speaking, the retirement benefits provided are reasonably similar to those provided by a private sector DB scheme. In the private sector, however, whilst some employees are members of DB schemes, many more are either members of DC schemes, holders of personal pensions, or have no Pillar 2 pension arrangements at all.

Pension increases

One further important point of difference between public and private sector schemes relates to pension increases. In public service schemes, pension increases are currently determined on the basis of pay parity i.e. in line with the pay of the grade at retirement. This contrasts with the situation in private sector schemes where, at best, pensions will be increased in line with retail price inflation and such increases (if any) are often discretionary rather than guaranteed.

Integration with Pillar 1

Most private sector DB schemes are integrated with the State social insurance system. That is to say, the contributions payable and the benefits received take account of the Pillar 1 pension. Within the public service, some scheme members are subject to integration while others are not. In very simplified terms, civil servants recruited after March 1995 pay the full rate of PRSI and are subject to integration; those recruited before that date pay a modified rate of PRSI, have no entitlement to Pillar 1 benefits and hence are not subject to integration.

⁵ Central Statistics Office (2004), *Quarterly National Household Survey – Pensions Update – Quarter 1 2004*

⁶ The Pensions Board (2005), *Annual Report 2004*

⁷ The Pensions Board (1998), *Securing Retirement Income*

Funding vs. PAYG

A final important point of difference is that the vast majority of public service occupational pension schemes are financed on a pay-as-you-go basis with the annual cost of pensions being met from current revenue (around 95% of staff have all their benefits met on a PAYG basis).

3.5 National Pensions Reserve Fund

The National Pensions Reserve Fund was established in 2001, in response to concerns about the capacity of future governments to continue to fund social welfare and public service pension liabilities on a pay-as-you-go basis.

Projections indicate that the age structure of the population will undergo major change over the coming decades with the proportion of persons of working age relative to those over 65 years of age projected to fall from the current ratio of 5:1 to less than 2:1 by mid-century. This ageing of the population will give rise to substantial increases in the costs to the Exchequer of public service and social welfare pensions and on the capacity to fund them on a PAYG basis.

The purpose of the Fund was to move away from complete reliance on the pay-as-you-go system and introduce part-prefunding of future social welfare and public service pension liabilities. To that end, it involves the statutory setting aside and investing of 1% of GNP annually (until 2055) to meet part of the cost of those future pensions. The government may also make additional contributions to the Fund where circumstances allow. At its inception, the Fund received an initial contribution of some IR£5 billion (€6.35 billion) comprising the net proceeds of the sale of Telecom Eireann and 1% of GNP in 1999 and 2000.

As at 31 December last, the Fund amounted to some €11.7 billion. No money can be drawn down before 2025 and from then on drawdowns will continue until at least 2055 in accordance with Ministerial rules related to the growth of the percentage of over 65s in the population.

4 Description of alternative systems for assessment

4.1 Introduction

In this chapter we describe the five alternative systems which the Pensions Board has chosen for analysis. The details of the five systems in question are set out below and are also summarised in a table in Appendix A.

4.2 Alternative System 1

Under this system, the contributory old age pension would be set at a level of 34% of the previous year's gross average industrial earnings (i.e. the same level as assumed in modelling the current system).

The existing voluntary supplementary pension system would continue as at present, but with some changes to the tax relief on contributions. Specifically, all employee contributions would give rise to a tax credit at the top rate of income tax (i.e. 42%), with an equivalent benefit for non-taxpayers. The qualifying income for these purposes would be capped at the current PRSA/RAC income limit. Employer contributions would be allowable as a business expense, again subject to the PRSA/RAC limits.

As at present, the investment income and capital gains of pension funds would be exempt from tax, and there would be no change to the taxation of pension benefits.

4.3 Alternative System 2

Under this system, the contributory old age pension would be set at a level of 34% of the previous year's gross average industrial earnings (i.e. the same level as assumed in modelling the current system).

A mandatory supplementary defined contribution pension system would be introduced, with a total contribution rate of 10% (which, for modelling purposes, is assumed to be split 50:50 between employers and employees) payable on pensionable earnings. Pensionable earnings would be defined for this purpose as earnings above the level at which employee PRSI becomes payable (currently approximately €15,000) up to a ceiling of twice average industrial earnings.

Further voluntary employer and employee contributions would be permitted, and these would qualify for tax relief in the same way as under Alternative System 1. That is to say, all employee contributions would give rise to a tax credit at the top rate of income tax (i.e. 42%), with an equivalent benefit for non-taxpayers. The qualifying income for these purposes would be capped at the current PRSA/RAC income limit. Employer contributions would be allowable as a business expense, again subject to the PRSA/RAC limits.

As at present, the investment income and capital gains of pension funds would be exempt from tax, and there would be no change to the taxation of pension benefits.

4.4 Alternative System 3

This system is identical to Alternative System 2, except that the mandatory defined contribution scheme would be operated by the State rather than by private-sector institutions.

4.5 Alternative System 4

Under this system, the contributory old age pension would be set at a level of 34% of the previous year's gross average industrial earnings (i.e. the same level as assumed in modelling the current system).

A mandatory supplementary State earnings-related system would be introduced, providing a benefit of 1% of revalued annual pensionable earnings for each year of contribution. Pensionable earnings would be defined for this purpose as earnings above the level at which employee PRSI becomes payable (currently approximately €15,000) up to a ceiling of twice average industrial earnings.

The contribution rate for this System would be set at a rate which is calculated to be cost-neutral in the long-term. As with Alternative Systems 2 and 3, contributions are assumed to be split equally between employers and employees.

Further voluntary employer and employee contributions would be permitted, and these would qualify for tax relief in the same way as under Alternative Systems 1 to 3. That is to say, all employee contributions would give rise to a tax credit at the top rate of income tax (i.e. 42%), with an equivalent benefit for non-taxpayers. The qualifying income for these purposes would be capped at the current PRSA/RAC income limit. Employer contributions would be allowable as a business expense, again subject to the PRSA/RAC limits.

As at present, the investment income and capital gains of pension funds would be exempt from tax, and there would be no change to the taxation of pension benefits.

4.6 Alternative System 5

Under this system, the contributory old age pension increases from 34% to 50% of the previous year's gross average industrial earnings with immediate effect.

The additional cost of this increase in the OACP would be met by a separately identifiable contribution (payable by employers and employees) at a rate which is calculated to be cost-neutral in the long-term.

Other than this increase in the OACP, the current system continues unchanged save for one amendment to the rules for tax relief on contributions to Pillar 2 arrangements: the contributions which would attract relief (both employer and employee) would be capped at the PRSA/RAC income limit.

5 Methodology and assumptions

5.1 Introduction

In this chapter we provide a high-level introduction to the methodology and assumptions employed in our assessment of the current Irish pension system and the five alternative systems.

5.2 Methodology

5.2.1 Exchequer costs & sustainability

In broad terms, our approach to the main task of assessing the cost and sustainability of the various pension systems was as follows:

- We first produced demographic & economic projections which formed the basis for our projections of the economy, population and labour force.
- Having gathered the relevant data, we analysed and modelled the features of the pension systems in order to project the net cost to the Exchequer of each system.
- In doing we looked at the four components of each of the systems – Pillar 1, public service Pillar 2, private sector Pillar 2 and the National Pensions Reserve Fund. For Pillar 1 and public service Pillar 2, we relied heavily on work undertaken by the Department of Social and Family Affairs and the Department of Finance respectively. The key was to ensure harmonisation and consistency between the approaches taken in respect of each component.
- We then aggregated the results for each component to provide a picture of the overall net cost to the Exchequer.

Based on these projections we were then able to comment about the sustainability of each of the systems.

5.2.2 Economic/competitiveness/employment impacts

In assessing the impact of the various alternative systems, we needed to undertake a quantitative assessment of the possible impacts on macroeconomic variables such as GNP, employment and unemployment.

In very simple terms, mandatory pension contributions for employers and employees will act like taxes. In the case of employers, the necessity to make contributions above those that they are currently making will be seen as increasing the price of labour. This in turn will reduce the demand for labour. In the case of employees, any mandatory contributions in excess of currently pension contributions will reduce the attractiveness of being in the labour market and so will lead to reductions in labour supply. Reductions in both labour supply and labour demand will lead to reductions in employment and GNP. In order to quantify the size of the impact, it is necessary to simulate each pension system in a model of the macro-economy.

In modelling the impact of the various systems, we took the following approach.

- We began by estimating the aggregate value of the additional contributions that were implied by each of the systems.
- We then treated the aggregate contribution value as an amount of revenue that needed to be raised by imposing higher taxes on employers and employees, whereby the tax take would be the same for each group.
- Finally, using the ESRI's HERMES model of the Irish economy, we simulated the impact of increasing taxes on employers and employees to the level implied by Systems 2 to 5.

Before leaving this section, it is important to make two additional points that qualify the results in certain ways. First, while we have looked at the labour market in an aggregated manner, it is possible that the employment impacts would be focussed on certain groups. In particular, as higher paid people are currently more likely to enjoy pension coverage, the marginal cost of any new system is more likely to be borne by lower paid people and so any employment effects may be concentrated on that group. Second, in producing our results we have not attempted to capture the possible impact of increased pension coverage in attracting people into the labour market. We have simply viewed any contributions as a tax but it is possible that people may factor in the long-run benefit of increased pension coverage into labour supply decisions.

5.2.3 Inter-generational equity

Issues of inter-generational equity generally come to the fore where there are proposals to move from a pay-as-you-go system to a funded system (or vice versa). For those systems where this is a feature, we consider and comment on issues of inter-generational equity from an economic perspective.

5.2.4 Intra-generational (re)distributive effects

We comment qualitatively on each system in terms of its intra-generational (re)distributive effects, if any. We also examine the projected pensions from each system in order to explore issues of adequacy.

5.2.5 Administration costs and relative efficiency

The financial projection model which we use to assess the net cost to the Exchequer of the various systems includes an assumption for the administration costs involved (which varies from one type of system to the next). For each system, the precise level of cost is open to debate (our assumptions are set out in the relevant chapters for each system) but we are satisfied that the relativities between the systems are reasonable. Our underlying assumption is that mandatory systems should be cheaper to run than voluntary ones, and State-run mandatory systems should be cheaper than private sector ones. (This latter assumption is not a comment on the relative efficiency of the public and private sectors, it merely reflects the savings which should be possible in a single-provider system, whoever operates it).

5.2.6 The relative merits of funding versus pay as you go

A key decision in designing a pension system is whether to rely on an unfunded pay-as-you-go (PAYG) system or to fund pensions by investing the contribution income received. There are important differences between these two approaches, but both involve a transfer of resources from the working population to pensioners and both are affected by demographic changes (although not identically). The economic theory of funding versus PAYG is quite involved⁸ and its relevance to the assignment in hand is questionable.

Rather, it seems to us that the main advantages of a funded system over a PAYG system relate more to questions of financial discipline and transparency:

- the exercise of funding (unlike PAYG) quantifies future liabilities;
- the true cost of any changes to pension terms is quantified and is immediately apparent under a funded system (unlike under a PAYG system where the immediate cashflow cost may be negligible); and,
- funding can help to smooth the cost of pensions over time.

8 See Appendix B of The Pensions Commission (UK) (2004), *Pensions: Challenges and Choices* for a detailed treatise on PAYG versus funding.

5.2.7 Effect on the national savings rate

The impacts of pensions policies and structures have been investigated in economic literature. However, it is on the theoretical side of the literature that most results have been developed rather than on the empirical side. For this reason, our remarks in later chapters relate largely to the direction of possible changes in savings in response to the various policy options but not to the magnitude of these changes. Even with regard to the theoretical material, we should note that few clear-cut predictions exist and the interactions between savings for various purposes are complex and so difficult to predict.

5.3 Assumptions

5.3.1 Introductory comments

Clearly, when projecting the future development of any pensions system over a 50 year period, a great many assumptions are required.

In the following sections of this chapter we briefly summarise the key assumptions used in our work. More detail on the assumptions we used when assessing the current Irish pension system is provided in Chapters 6 and 7. Any changes which we made to those assumptions to reflect the impact of the proposed alternative systems are summarised in section 5.7.3 below and are discussed in more detail in the chapters that deal with our assessment of those systems (Chapters 9 to 13).

Our chosen assumptions reflect the discussions we have had with the executive of the Pensions Board. Those discussions have impressed upon us that, when it comes to projecting the current pension system, we should endeavour to project it on an “as is” basis and should set our assumptions accordingly. We were also instructed to avoid undue complexity in our assumptions, if at all possible.

When it came to making changes to our base assumptions to reflect the potential impact of alternative systems, we discussed possible approaches with the executive of the Pensions Board. The changes to assumptions for modelling alternative systems, as set out in this report, reflect the outcome of those discussions.

Our assumptions were also circulated to the NPR Steering Committee and we took account of comments received.

5.3.2 Types of assumptions required

The assumptions required to conduct a financial assessment of a pension system may be categorised under the following main headings:

- Demographic assumptions
- Economic assumptions
- Labour force & earnings assumptions
- Pension system assumptions

The following sections deal with each of these in turn. Further detail on demographic, economic and labour force assumptions is provided in Chapter 6. Further details on the pension system assumptions used in assessing the current system are set out in Chapter 7.

5.4 Demographic assumptions

Population projections out to 2056 have been generated for the purposes of this report using the ESRI’s demographic model. Full details of the model and of the projections are provided in Chapter 6 but here we provide a brief overview.

The starting point for the projections is the population, by yearly-age and gender, as measured by the Census of 2002. By imposing assumptions for fertility, mortality and migration on the 2002 baseline, it is possible to generate a picture of the population as it evolves over time. Clearly, the choice of assumptions is crucial in determining the path of population developments. In order to minimise any controversy surrounding our choice of assumptions, and also in an effort to bring consistency with the work of others, we have opted to use assumptions that were also used by the CSO in producing population projections.

One important consequence of using the CSO's assumptions is that, as their mortality assumptions incorporate an allowance for future mortality improvements, the average life expectancy is projected to increase considerably over the period in question (see Table 6.4 and Table 6.5 in section 6.4 for details). This has significant implications for the projected cost of the various pension systems under investigation.

5.5 Economic assumptions

In assessing alternative pension systems it is necessary to be able to express aggregate pension benefits or contributions as percentages of GNP. For this reason, we needed to generate a long-run GNP series (out to 2056). The methodology and assumptions which were used in projecting future GNP are set out in Chapter 6. In summary, however, the growth in GNP was projected as a function of growth in employment and productivity.

Assumptions for earnings and price inflation were also derived, consistent with the GNP projections. We also made certain assumptions for future investment returns on pension fund assets. Once again, the details are set out in Chapter 6.

5.6 Labour force & earnings assumptions

In order to project the size of the labour force we made assumptions about the level of labour force participation by gender and age which we then applied to the projected population numbers. In summary, we held the male age-specific participation rates constant at their current levels, whilst for women we assumed a degree of increase in the participation rates in the 35-54 age range.

We also needed to segment the labour force into earnings bands at each age. We did this on the basis of PRSI data for 2003 which was supplied by the Department of Social and Family Affairs. We then assumed that, for each age, the proportion of the labour force in each of the earnings bands would remain constant over time. We further assumed that earnings would inflate in the future in accordance with our earnings inflation assumption (see 6.8.1).

Further detail on our labour force & earnings assumptions is provided in Chapter 6.

5.7 Pension system assumptions

In order to model the future evolution of the various pension systems, we had to make certain assumptions. These varied from system to system, reflecting:

- (a) our belief (which we discussed with the executive of the Pensions Board) that introducing some of the alternative systems would be likely to have an impact on the existing arrangements (thus necessitating a revision of the assumptions relevant to those arrangements); and,
- (b) the fact that some of the alternative systems had features which are not present in the current system and for which additional assumptions were therefore required.

All assumptions were fully discussed and agreed with the executive of the Pensions Board and the Board's NPR Steering Committee.

5.7.1 General assumptions

Before dealing with the assumptions for each pension system, there are a number of key assumptions which were used across the board:

- Retirement age: We assumed a retirement age of 65⁹ for all systems.
- Indexation of flat-rate benefits etc.: We assumed that flat-rate Pillar 1 benefits would increase in line with earnings inflation. We similarly assumed that contribution thresholds/limits (e.g. PRSI threshold) would similarly increase in line with earnings.
- Tax-free lump sum at retirement: We assumed that Pillar 2 private sector retirees would take the full tax free lump sum. For modelling purposes, this was taken as 25% of their assets at retirement (which is the position for defined contribution retirees but is not strictly accurate for defined benefit retirees).

5.7.2 Current system

The detailed assumptions which we used in assessing the current system are set out in Chapter 7. In this section we provide a high-level summary some of the more important assumptions.

Pillar 1

Current data provides us with information on the proportion of the over-65 population in receipt of various benefits. By making assumptions on how these proportions will move over time, we calculated the number of recipients under the various payment categories out to 2056, using our population projections. The relevant assumptions are detailed in Table 5.1.

Table 5.1: Percentage of the population aged 66 and over covered by Social Welfare schemes

	2005		2056	
	Male	Female	Male	Female
Old Age Contributory Pension (100%)	41.7	11.7	80.0	57.0
Old Age Contributory Pension (98%)	15.9	5.9	11.0	12.0
Old Age Contributory Pension (75%)	1.9	0.9	1.5	2.0
Old Age Contributory Pension (50%)	2.7	1.5	3.5	4.5
Pre-1953 Contributory Pension	8.8	2.6	0.0	0.0
Other contributory pensions	5.1	2.9	0.0	0.0
Invalidity Pension	1.5	1.2	1.0	1.0
Old Age Non-Contributory Pension	19.1	20.3	2.0	2.0
Qualified Adults*	–	12.8	–	7.0
Widow(er)'s Contributory Pension – full	2.0	23.5	0.5	12.0
Widow(er)'s Contributory Pension – reduced*	–	4.3	–	0.0
Widow(er)'s Non-Contributory Pension*	–	5.3	–	1.0
Other payments (carers etc.)*	–	1.4	–	1.0
Total covered by SW schemes	98.7	94.3	99.5	99.5
– of which, payments to non-residents	(10.7)	(7.9)	(1.5)	(1.5)
Residents covered by SW schemes	88.0	86.4	98.0	98.0

* The number of males under these headings is negligible and they are included instead under other headings.

Some of the more important assumptions are as follows:

- The proportion of males aged 66 and over who qualify for a full contributory pension is assumed to rise from the current level of 41.7% to 80% over the period to 2056. The corresponding increase for females is from 11.7% to 57.0%. These increases capture, inter alia, the increasing levels of female participation and the increasing numbers of public servants covered by the PRSI system.
- The proportion of the over-65 population in receipt of non-contributory pensions is assumed to fall from the current level (19.1% of men; 20.3% of women) to 2% by 2056.
- The percentage of the over-65 population receiving no social welfare benefits is assumed to fall to 2% by 2056.

With regard to payment rates, we assumed that the contributory old-age pension is indexed in line with earnings inflation and that the same absolute increases (i.e. in euro amounts) are applied to other payments.

Public service Pillar 2

The Department of Finance provided us with projections of the gross benefit outgo in relation to public service pensions out to 2056. These projections were essentially an updating of the work undertaken by the Commission on Public Service Pensions in 2000 and in most cases the assumptions follow those used by the Commission.

The main change in assumptions from those used by the Commission was an updating of the mortality assumption to be broadly consistent with the mortality rates underlying our demographic projections (as set out in Chapter 6). Other changes included an assumption that the Pillar 1 pension increases in line with public service pay (as opposed to the previous assumption of 1% over price inflation) as well as an allowance for changing patterns of recruitment.

Public service employment numbers are assumed to remain constant at the current level of approximately 280,000 (as measured on a full-time equivalent basis).

Private sector Pillar 2

We gathered data on the current private-sector Pillar 2 system (i.e. membership, contributions, assets, pensioners etc.) from various sources and made assumptions about how each of these items would evolve in the future.

The number of members was determined by looking at data from the Pensions Board and from life assurance companies' regulatory filings. The coverage rates from the CSO survey provided a useful check on these numbers.

Total contributions were determined by applying assumed contribution rates (which varied by age, income and type of pension arrangement). It was possible to cross-check some of these numbers against various sources such as life assurance company filings and Revenue Commissioners estimates¹⁰ of tax relief on contributions).

Total current assets were estimated from the most recent IAPF asset survey¹¹ and from life assurance data. Future assets were projected from this base allowing for contributions, benefit payments, expenses and investment returns.

¹⁰ Revenue Commissioners (2003), *Statistical Report 2003*

¹¹ Irish Association of Pension Funds (2005), *Asset Allocation Survey 2004*

In determining the total amount of private-sector pensions currently in payment we took our data from life assurance companies' regulatory filings and from data gathered by the Society of Actuaries in Ireland (for use in an investigation into pensioner mortality¹²). We also made allowance for assets held in Approved Retirement Funds (ARFs). The total amount of pensions in payment was then projected forward using this starting point and adding the pensions payable to new retirees as further cohorts retire each year (and assuming life expectancies in line with our demographic assumptions).

Finally, in relation to expenses, we allowed for the explicit costs of selling, processing and administering pension products, and the explicit charges paid to fund managers by assuming a reduction in the yield earned on pension fund assets of 1.5% p.a. (The direct trading and investment costs had already been deducted in arriving at our assumed asset growth rates.)

National Pensions Reserve Fund

In projecting the development of the National Pensions Reserve Fund, our starting point was the value of the fund as at 31 December 2004. We then rolled the fund forward, allowing for contributions of 1% of our projected GNP figures and assuming a real investment return of 4.6% p.a. (see section 6.8.3 for details on the derivation of this rate). Drawdowns were assumed to commence in 2025 (at a low level) with subsequent annual drawdowns increasing in line with the growth in the over-65 population. More detail on our chosen assumptions regarding the pattern of drawdowns is provided in section 7.6.

5.7.3 Specific issues for each of the alternative systems

As mentioned in 5.3.1 above, when it came to assessing the alternative systems it was necessary to make changes to some assumptions to reflect the potential impact of the alternative systems on existing arrangements. Any such changes were agreed following discussions with the executive of the Pensions Board and the NPR Steering Committee. It was also necessary, in some cases, to introduce additional assumptions which were not required for the current system.

The detailed changes to the base assumptions are set out in the relevant Chapters (8 to 13) which deal with each of the alternative systems in turn. What follows is a brief summary of some of the more important ones.

Alternative System 1

When assessing this system, we assumed that the coverage rates of the lower paid would increase by 10 percentage points over the next 10 years, reflecting the increased attractiveness of pensions to lower earners given the changes in tax reliefs. It should be noted that this is not intended to be a prediction of the effect of introducing this system, merely a mechanism for exploring the impact of increased participation amongst the lower income groups.

Another feature of this system is the proposal to limit the tax reliefs available to very high earners. This proposal will help to offset the additional cost of providing tax relief to lower earners. It should be noted, however, that (as agreed with the executive of the Pensions Board) our quantitative projections of the net Exchequer cost of this system make no allowance for the potential impact of these proposed curbs (on the basis that any cost savings are projected to be small).

Alternative System 2

When assessing this system, we assumed that there would be no future new entrants to existing voluntary schemes, except in the highest income band (as everyone, other than the lowest earners, will be joining the new mandatory arrangements). We also assumed that member contributions to existing voluntary arrangements would reduce by the amount of the mandatory contributions payable. Employer contributions to existing voluntary schemes were assumed to decrease to take account of the employer mandatory contributions which would become payable.

¹² The Society of Actuaries in Ireland, *Pensioner mortality investigation* (presented to an Evening Meeting of the Society on 1 June 2004)

In projecting the cost of tax relief on contributions under this system, we allowed for the fact that mandatory contributions would qualify for tax (& PRSI) relief, in accordance with the system specification laid down by the Pensions Board.

In relation to expenses, we assumed a reduction in yield of 1.0% (rather than 1.5% p.a.) on mandatory assets to reflect the assumption of lower expenses under a mandatory system.

Finally, we assumed that all public servants would be subject to the mandatory arrangements. As we note in section 10.2, this is a problematic issue and it is open to debate as how best to allow for public servants in the context of the introduction of a mandatory Pillar 2 system. The decision to include public servants within the realm of the mandatory scheme for the purposes of our financial modelling was made on the basis that it would provide more useful information than the alternative approach of excluding them. (The resulting additional cost would be easily identifiable by comparing the cost of public service pensions across the various systems.)

Alternative System 3

As this system is a variant of Alternative System 2, the methodology and assumptions used to assess this system were very similar to those set out for System 2 above.

The only change was a lower reduction in yield (0.5% rather than 1.0% in Alternative System 2) to reflect an assumption of lower costs for the mandatory component than under Alternative 2.

One further point in relation to System 3 relates to the issue of guaranteeing rates of return on contributions invested in a State-run defined contribution scheme. As outlined in section 3.2.2 it is not usually the case that defined contribution schemes offer any guarantees of minimum rates of return, whether on a year-by-year basis (e.g. the fund can not have a negative return in any year) or on a cumulative basis (e.g. a minimum underpin of contributions paid, perhaps rolled up at a modest rate of interest). However, if the State is compelling workers to contribute to a defined contribution plan, there is a strong argument to be made that it should provide some form of guarantee. From an economic perspective, providing such guarantees has a cost but it is difficult to quantify without knowing the precise system specification. For that reason we confine ourselves to commenting qualitatively on this point. (The same point could, arguably, apply to Alternative System 2 also.)

Finally, it should be noted that, in modelling this system, we assumed that it would be run on a funded basis.

Alternative System 4

As Alternative System 4 is another State-run mandatory system (albeit a defined benefit rather than defined contribution one), the methodology and assumptions used to assess this system were quite similar to those set out above in respect of System 3.

The one significant change was that, in calculating the contribution rate required to fund the mandatory earnings-related system, we assumed an investment return equal to GNP growth (rather than a rate of return based on investment in capital market assets).

As for Systems 2 and 3, we assumed that all public servants would be subject to the mandatory arrangements. We also allowed for the fact (as for Systems 2 and 3) that mandatory contributions would be eligible for tax relief at 42% (and for PRSI relief as well), in accordance with the system specifications laid down by the Pensions Board.

Alternative System 5

For this system, we made similar coverage and contribution assumptions for the existing voluntary Pillar 2 arrangements as for Systems 2 to 4 (i.e. we assumed that only high earners would join voluntary schemes in the future and we adjusted voluntary contributions to take account of the mandatory contributions payable).

We assumed that the additional Pillar 1 pension (i.e. the extra amount resulting from the increase from 34% to 50%) would be taxed at 20%.

In contrast to Systems 2 to 4, our treatment of public service workers assumed that the additional Pillar 1 pension would only be payable to those who were integrated with the social insurance system. We also assumed that the contributions to fund the increase in Pillar 1 benefits would be eligible for tax relief at the contributor's marginal rate (and for PRSI relief as well).

6 Demographic and economic projections

6.1 Introduction

In this chapter, we set out the assumptions underlying our projections of the population and the economy out to 2056. We then go on to provide details of the projections themselves, focussing on variables of particular interest such as the projected percentage of the population over the age of 65. Our next step is to outline the assumptions that allow us to generate labour force projections from the population projections. From labour force projections, we then move on to projections of GNP.

6.2 Key demographic assumptions

As noted in Section 5.2, the assumptions we use in generating population projections are generally taken from the CSO. While the CSO publish population projections out to 2036¹³, they do not publish figures out to 2056. However, they do provide the Department of Social and Family Affairs with projections out to 2056. In preparing our projections, we have liaised with the CSO and used both the published and unpublished assumptions.

6.3 Population projections

We have produced population figures using three sets of assumptions. Details under each heading are as follows.

6.3.1 Central projection

Our central projection is based on the CSO's F2M2 assumptions, as follows:

Fertility (CSO's F2) – the total fertility rate is assumed to decline from the current level of 1.98 to 1.85 by 2011 and to remain constant thereafter.

Mortality – improvements in mortality rates between 1986 and 2002 are assumed to continue at the same rate out to 2036 and thereafter to continue improving at half the rate assumed for 2002-2036. This leads to the following life expectancies: 84.2 years in 2056 for males and 88.6 for females.

Migration (CSO's M2) – immigration to continue but at more moderate levels than has been recently experienced.

The precise net inflows are as follows:

- +30,000 per annum in 2002/2006
- +20,000 per annum in 2007/2011
- +10,000 per annum in 2012/2016
- + 5,000 per annum in 2017/2021
- + 5,000 per annum in 2022/2026
- + 5,000 per annum in 2027/2031
- + 5,000 per annum in 2032/2036
- + 5,000 per annum in 2037/2056

13 Central Statistics Office (2004), *Population and Labour Force Projections 2006 to 2036*

Based on these assumptions, we present in Table 6.1 some summary measures of the projected population and its structure out to 2056. Looking first at the total population, it can be seen that the population is forecast to rise from 4.17 million in 2006 to 5.22 million in 2056, an increase of 25%. What is of greater interest from the perspective of this report is the projected change in the structure of the population. The proportion of the population aged 65 and over is projected to rise from 11% in 2006 to 29% in 2056. Looking at this process of population ageing in terms of the dependency ratio, we can see that the old-age dependency ratio¹⁴ rises from 16% in 2006 to 53% in 2056.

Table 6.1: Population structure 2006 to 2056 (000s); central assumptions

	2006	2016	2026	2036	2046	2056
0-14	868	969	889	822	844	807
15-64	2,834	3,048	3,176	3,176	2,980	2,879
65+	464	620	844	1,105	1,403	1,532
Total	4,165	4,638	4,909	5,104	5,228	5,219
0-14	21%	21%	18%	16%	16%	15%
15-64	68%	66%	65%	62%	57%	55%
65+	11%	13%	17%	22%	27%	29%
Old-age DR	16%	20%	27%	35%	47%	53%

6.3.2 Impact of higher immigration assumption

In the second set of population projections we use the CSO's higher immigration assumption (labelled M1 by the CSO).

The assumed net inflows under this scenario are as follows:

- +30,000 per annum in 2002/2006
- +30,000 per annum in 2007/2011
- +30,000 per annum in 2012/2016
- +20,000 per annum in 2017/2021
- +20,000 per annum in 2022/2026
- +15,000 per annum in 2027/2031
- +15,000 per annum in 2032/2036
- +15,000 per annum in 2037/2056

In Table 6.2, we show the population structure along the lines shown in Table 6.1. The main points to note are the higher rate of population growth and the slower pace of population ageing. It should also be noted however that immigration in no way eliminates population ageing.

¹⁴ Defined as the population aged 65 and over expressed as a percentage of the population aged 15-64.

Table 6.2: Population structure 2006 to 2056 (000s); higher immigration scenario

	2006	2016	2026	2036	2046	2056
0-14	868	1,007	994	954	990	990
15-64	2,834	3,176	3,444	3,576	3,512	3,485
65+	464	625	858	1,133	1,464	1,678
Total	4,166	4,808	5,296	5,663	5,966	6,152
0-14	21%	21%	19%	17%	17%	16%
15-64	68%	66%	65%	63%	59%	57%
65+	11%	13%	16%	20%	25%	27%
Old-age DR	16%	20%	25%	32%	42%	48%

6.3.3 Impact of alternative mortality assumption (increased longevity)

Our third and final set of population projections arises from altering the assumptions in respect of mortality. In their work, the CSO assumed a reduced rate of mortality improvements after 2036. Here, we depart from this assumption and assume that mortality improvements continue at the same rate as between 2002 and 2036. The result of this is to increase life expectancy to the following levels in 2056: for men, 85.5 years and for women 89.3 years. In Table 6.3, we present the resulting population structure. These figures should be compared to those in Table 6.1 – it can then be seen that the ageing of the population is now more pronounced. For example, the old-age dependency ratio is now projected to be 55% in 2056 as opposed to 53% under the central scenario.

Table 6.3: Population structure 2006 to 2056 (000s); increased longevity scenario

	2006	2016	2026	2036	2046	2056
0-14	868	969	889	822	845	808
15-64	2,834	3,048	3,176	3,176	2,982	2,883
65+	464	620	844	1,105	1,421	1,591
Total	4,165	4,638	4,909	5,104	5,247	5,281
0-14	21%	21%	18%	16%	16%	15%
15-64	68%	66%	65%	62%	57%	55%
65+	11%	13%	17%	22%	27%	30%
Old-age DR	16%	20%	27%	35%	48%	55%

6.4 Life expectancy

One important consequence of using the CSO's assumptions is that, as their mortality assumptions incorporate an allowance for future mortality improvements, the average life expectancy is projected to increase considerably over the period in question. This has significant implications for the projected cost of the various pension systems under investigation.

Table 6.4 shows the projected remaining life expectancy for males and females reaching age 65 at various years in the future¹⁵. In summary, those reaching 65 in 2056 are projected to live 6 years longer than those reaching 65 next year.

Table 6.4: Life expectancy at 65, 2006 to 2056, central scenario

	2006	2016	2026	2036	2046	2056
Male	16.0	17.6	19.2	20.6	21.3	22.0
Female	19.4	20.9	22.4	23.9	24.6	25.3

The corresponding life expectancies on the alternative lighter mortality scenario are set out in Table 6.5 for comparison. In this case, the increase in life expectancy for 65 year olds is projected to reach to over 7 years by 2056.

Table 6.5: Life expectancy at 65, 2006 to 2056, increased longevity

	2006	2016	2026	2036	2046	2056
Male	16.0	17.6	19.2	20.6	22.0	23.2
Female	19.4	20.9	22.4	23.9	25.3	26.7

6.5 Labour force projections

In order to generate labour force projections, we proceeded as follows.

Based on the population projections, we have numbers in each yearly age cohort and for each gender. We then determined the size of the labour force by applying the proportion of each age/gender group who participate in the labour force. Hence, we needed to make assumptions on age/gender participation rates out to 2056.

The approach we adopted was as follows. In the case of men, we have assumed that the age-specific participation rates remain constant at their current levels out to 2056. In the case of women, we thought it appropriate to assume some degree of increase. While a range of possible assumptions could have been made, the approach we settled on was to allow participation rates for the age groups 35-44 and 45-54 to converge to the (current) EU average over the period to 2015. In the case of women aged 35-44, the implied increase was from 66% to 77%. For women aged 45-54, the increase was from 60% to 71%. In the case of other age groups, the participation rates in Ireland do not differ greatly from the EU average and so no convergence was assumed.

The resulting labour force projections are summarised in Table 6.6. In summary, the labour force is projected to grow over the period to 2026, to stabilise at around the 2026 level until 2036 and to fall back thereafter. This reflects the projected development of the population over that period (see Table 6.1).

The age structure of the labour force is also projected to shift considerably over time. Under-35s account for almost 44% of the 2006 labour force, but this is projected to fall to 32% by 2056. Conversely, over-55s account for 12% of the 2006 labour force, but 19% of the projected 2056 labour force.

¹⁵ Note that the projected future life expectancies quoted in Table 6.4 and Table 6.5 (and elsewhere in this report) have been calculated allowing for projected improvements in mortality until the date in question, but with no allowance for expected future mortality improvements beyond that date. This is the approach which has been adopted by the CSO (and others) when quoting projected life expectancies and we have adopted the same presentational approach for ease of comparison. This means that the quoted life expectancies do not tell the full story – on the basis of the assumed continued improvements in mortality, they understate the “true” position. It is important to note, however, that this is purely a presentational issue – all of our calculations allow fully for all projected mortality improvements.

Table 6.6: Labour force projections (000s), 2006 to 2056, central scenario

	2006	2016	2026	2036	2046	2056
15-24	291	242	285	277	239	245
25-34	585	537	446	520	491	431
35-44	490	634	567	476	550	521
45-54	392	496	599	538	454	523
55-64	207	254	303	369	324	281
65+	36	49	68	89	113	123
Total	2,001	2,213	2,268	2,268	2,170	2,125

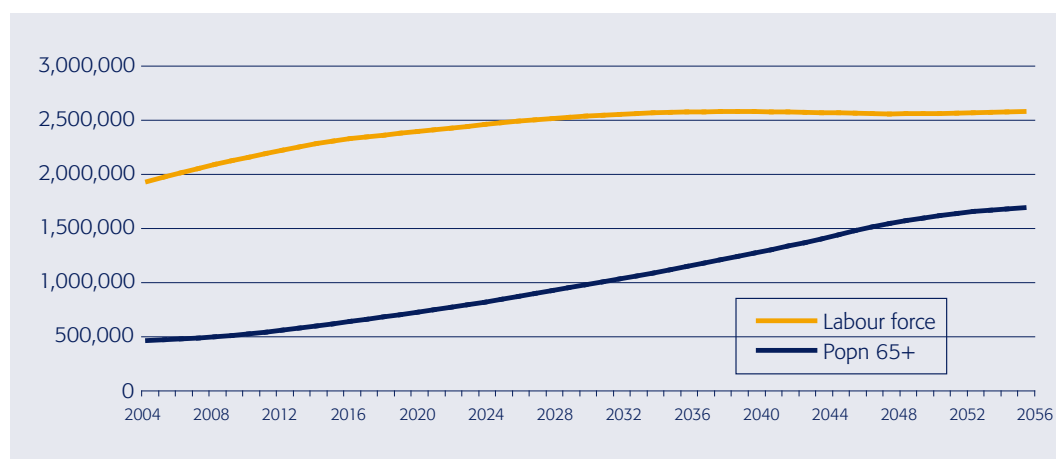
Table 6.7 compares the labour force projections for all three demographic scenarios. Not surprisingly, the increased immigration scenario leads to a substantial increase in the size of the labour force when compared to the central scenario. It also results in a labour force which is broadly stable in overall size terms over the period 2036-2056. One other feature of the increased immigration scenario (not shown in Table 6.7) is that the age-structure of the labour force is also projected to diverge from that of the central scenario, with a somewhat higher average age in 2056 on the increased immigration scenario. Finally, as expected, the increased longevity scenario makes little or no difference to the labour force projections.

Table 6.7: Labour force projections (000s), 2006 to 2056

	2006	2016	2026	2036	2046	2056
Central	2,001	2,213	2,268	2,268	2,170	2,125
Higher immigration	2,001	2,314	2,476	2,561	2,548	2,566
Increased longevity	2,001	2,213	2,268	2,268	2,173	2,133

In Figure 6.1, we show the projected labour force, along with the projected population aged 65 and over, to provide a sense of the growing difficulties that any non-funded system would present. Figure 6.1 is based on the higher immigration scenario and so is the most favourable in terms of labour force growth. Even still, the growing dependency difficulties are readily seen especially after 2030 when the labour force remains constant but the older population continues to increase.

Figure 6.1: Labour force and Population aged 65 and over (high migration scenario)



6.6 Labour force earnings

In arriving at a figure for the current level of income earned by the labour force, we used income figures taken from analysis of PRSI data for 2003 which was supplied by the Department of Social and Family Affairs. As well as providing the total level of income¹⁶, this data also analysed the PRSI payers by age and income decile.

Based on this data, we aggregated some deciles to arrive at five income bands (not quintiles). We arrived at the analysis of labour force earnings as set out in Table 6.8.

Table 6.8: Labour force (000s) aged 18-64, analysed by earnings band

Age	Band 1 Up to €16k	Band 2 €16k - €26k	Band 3 €26k - €40k	Band 4 €40k - €53k	Band 5 Over €53k	Total
18-20	37	4	1	0	0	42
20-24	102	53	28	3	1	187
25-34	153	128	161	76	50	568
35-44	122	93	107	69	82	473
45-54	111	73	79	48	66	377
55-59	44	25	26	15	20	130
60-64	27	13	14	7	8	69
Total	596	389	416	218	227	1,846

In our projections we assumed that, at each age, the proportion of the labour force in each of the five earnings bands would remain constant over time. We further assumed that earnings would inflate in the future in accordance with our earnings inflation assumption (see 6.8.1).

Based on the PRSI data, and allowing for earnings inflation for the period from 2003-2005, the total earnings of the labour force aged 18-64 were estimated at some €57 billion in 2005.

6.7 GNP projections

In assessing alternative pension systems it is necessary to be able to express aggregate pension benefits or contributions as percentages of GNP. For this reason, we needed to generate a long-run GNP series (out to 2056). We did so as follows.

Taking GNP in 2005 as our starting point, subsequent growth is determined by the growth in employment and the growth in output per worker (i.e. productivity). Employment growth is derived from increases in labour force growth, adjusted for unemployment. The growth in the labour force comes from the projections described in 6.5 above. With regard to unemployment, we assume a long-run value of 4%. On productivity, we assume a long-run growth rate of 2% per annum. Each of these assumptions is consistent with other work of this type such as the ESRI's Medium Term Review¹⁷.

The resulting central scenario GNP projections are summarised in Table 6.9. The figures for the increased longevity scenario are virtually identical to these.

¹⁶ The income figures provided are net of employee pension contributions.

¹⁷ Economic and Social Research Institute (2003), *Medium-Term Review 2003-2010*

Table 6.9: GNP projections (€m), 2006 to 2056, central scenario

	2006	2016	2026	2036	2046	2056
Real GNP (2004 base)	134,735	192,804	243,775	297,160	346,570	413,743
Average 10 year growth % p.a.		3.7%	2.4%	2.0%	1.6%	1.8%
Nominal GNP	141,004	245,962	379,092	563,309	800,846	1,165,440
Average 10 year growth % p.a.		5.7%	4.4%	4.0%	3.6%	3.8%

The GNP projections on the higher immigration scenario are as set out in Table 6.10.

Table 6.10: GNP projections (€m), 2006 to 2056, higher immigration scenario

	2006	2016	2026	2036	2046	2056
Real GNP (2004 base)	134,737	201,633	266,105	335,541	406,942	499,426
Average 10 year growth % p.a.		4.1%	2.8%	2.4%	2.0%	2.1%
Nominal GNP	141,006	257,226	413,816	636,066	940,351	1,406,796
Average 10 year growth % p.a.		6.2%	4.9%	4.4%	4.0%	4.1%

6.8 Other economic assumptions

6.8.1 Earnings inflation

Real wage growth is assumed to equal productivity growth (3% currently, falling to 2% p.a. by 2021 and staying at that rate thereafter).

6.8.2 Price inflation

Price inflation is taken as equal to the GNP deflator used in the GNP projections (2.4% currently, falling to 2% p.a. by 2007 and staying at that rate thereafter).

6.8.3 Investment returns on pension fund assets

In determining the rate of investment return assumed to be earned in the future on pension fund assets, we began by deriving appropriate assumptions for each of the main asset classes. The four asset classes we looked at were index-linked bonds, conventional government bonds, corporate bonds and equities. (We made no explicit allowance for investment in property, but property could be considered to constitute a real asset with similar expected returns to equities).

Index-linked bonds (government guaranteed)

For index-linked bonds we assumed a real rate of return of 1.75% p.a. This is consistent with the current real yield on eurozone index-linked bonds. As this reflects the market's best estimate of what real interest rates will be over the next 20 to 30 years, the current yield is by definition the best estimate to assume for the future.

Nominal bonds (government guaranteed)

We assumed that a 1.75% p.a. real return would also apply to nominal fixed rate bonds. This is a valid assumption if we believe that monetary authorities will be successful at keeping future inflation steady, in line with current market expectations. If there is unanticipated inflation or deflation, real returns on nominal government bonds will be either lower or higher than our assumption.

Corporate bonds

Corporate bonds deliver a spread over government bonds to reflect credit risk and lower liquidity. The spreads vary with the credit rating of the bonds, from as low as 0.1% for some AAA-rated issuers to 3% or more for “junk” bonds. On the basis that pension fund investment in corporate bonds is likely to be restricted to (or at least heavily concentrated in) investment-grade bonds, we assumed an average net corporate bond spread of 0.5% above government bonds. (This would be consistent with a slightly higher gross spread and a small average default rate.)

Equities

In arriving at an appropriate assumption for the future real rate of return on equities, we have relied on the recent work in this field by Dimson, Marsh and Staunton of the London Business School¹⁸. They summarised the evidence for the historical equity risk premium (i.e. the amount by which equities outperformed government bonds) for 16 countries over 101 years. In determining their expected future risk premium, rather than just taking the historical average, they attempted to adjust for the historical impact of known factors and hence to derive an appropriate assumption for the future. In doing so they arrived at a range for the prospective real equity risk premium of around 3.5% to 5.25%.

Taking a point towards the middle of this range (say 4.25%) and adding it to our assumed real rate of return on government bonds (1.75%) gives an assumed future real rate of return for equities of 6.0% p.a.

To put this in context, the historic long-term average real rate of return on UK equities is around 5.5%, while in the USA the corresponding figure is about 7.3%. Our prospective assumption is above the UK historical average and below the US, therefore.

Finally it is worth commenting that any attempt to forecast equity returns from today, depends crucially on whether one views the current equity market as being at, above or below its equilibrium level.

It is also worth remembering that whilst equities are expected to outperform bonds over long periods, returns can be subject to significant risk over periods relevant to pension investment.

Trading costs

Because of trading costs, investors (such as pension funds) do not receive the full market return. Estimating the level of these costs is difficult, but some allowance has to be made.

The Financial Services Authority (FSA) in the UK published a paper¹⁹ which is believed to be one of the most detailed studies of trading costs. The paper is not specifically focused on pensions but its findings are likely to be broadly applicable to pension fund investment.

¹⁸ Dimson E., Marsh P. & Staunton M. (2002), *Triumph of the Optimists: 101 Years of Global Investment Returns*

¹⁹ James K. (2000), *The Price of Retail Investing in the UK*

Based on this work and on other data sources, the Pensions Commission²⁰ in the UK decided to assume 0.65% implicit costs for equity investment on average. The Pension Commission stated that it had not discovered any analysis of trading costs for bonds, but proposed to assume 0.25% for corporate bonds and 0.10% for government bonds in its modelling work. We have made the same assumptions.

Impact of demography on asset prices and rate of return

There are economic arguments to suggest that demographic factors can influence the prices of (and hence rates of return on) assets in the capital markets. These arguments lie behind the concerns which are sometimes advanced that the members of the “baby boom” generation will attempt to sell their accumulated pension assets to fund their retirement, leading to falling asset prices. There is general agreement among economists that these effects ought to be present, but there is less consensus on how large the effects might be. We have not attempted to make any allowance for these factors in our modelling of future investment returns.

Summary of assumed investment returns

Table 6.11 summarises our assumptions for the prospective real investment returns, net of trading costs, for the main asset classes.

Table 6.11: Assumed prospective real investment returns (% p.a.)

Asset class	Before trading costs	Allowance for trading costs	After trading costs
Index-linked bonds	1.75%	0.10%	1.65%
Government bonds	1.75%	0.10%	1.65%
Corporate bonds	2.25%	0.25%	2.00%
Equities	6.00%	0.65%	5.35%

Based on an assumption of a long-term average 60:40 equity/bond asset mix in defined benefit pension funds (and allowing for some corporate bond investment within the bond portfolio), these rates give an assumed real investment return for defined benefit schemes of 3.9% p.a.

Allowing for the effect of “life-styling” in defined contribution funds (whereby members’ assets are gradually shifted out of equities and into bonds as they approach retirement), we felt that a lower investment return assumption (3.6% p.a.) was appropriate for defined contribution arrangements.

Finally, based on its target strategic asset allocation policy of 87% in real assets and 13% in bonds (this target to be reached by 2009), it was appropriate to assume a higher investment return on the assets of the National Pensions Reserve Fund. Our assumed return of 4.6% p.a. is consistent with an 80:20 equity/bond asset mix, which we consider to be a reasonable assumption over the period as a whole, taking into account the Fund’s current asset mix, its target asset allocation and the likely need to increase the bond component in the long-term as the Fund matures.

20 The Pensions Commission (UK) (2004), *Pensions: Challenges and Choices*

Thus, in summary, we have:

Table 6.12: Assumed prospective real investment returns (% p.a., net of trading costs)

	Assumed rate of return
Defined benefit schemes	3.9%
Defined contribution arrangements	3.6%
National Pensions Reserve Fund	4.6%

The investment returns quoted in Table 6.12 apply to pre-retirement assets. For the post-retirement phase we assumed that benefits would be annuitised using annuity rates which are based on a real return assumption of 2% p.a.

7 Financial assessment of the current system

7.1 Introduction

Before examining the alternative systems suggested by the Pensions Board, we completed a detailed financial assessment of the current pensions system. To this end we have produced projections of:

- Cost of Pillar 1 pensions
- Revenues to the State from PRSI contributions
- Projected costs of public service Pillar 2 pensions
- Projected flows to and from the National Pensions Reserve Fund
- Contributions to private sector Pillar 2 pension arrangements
- Cost of tax relief on private sector Pillar 2 contributions
- Total projected assets of private sector Pillar 2 arrangements
- Cost of tax relief on investment income on private sector Pillar 2 arrangements
- Projected benefit payments from private sector Pillar 2 arrangements
- Tax revenue to the State from tax on private sector Pillar 2 benefits

We then produced a summary of the costs and revenues for each year of projection to give the projected net position for the Exchequer from the current system.

Finally, we also assessed the impact of the alternative assumptions for migration and longevity discussed in Chapter 6 above.

7.2 Key assumptions

The financial projections use the demographic and economic assumptions as set out in Chapter 6. However, the projections also require a number of assumptions to be made about the development of the current pension system. These are identified and commented on in the relevant sections of this chapter. For convenience, however, some of the key assumptions are listed here:

- The amount of the Pillar 1 pension increases to 34% of the previous year's gross average industrial earnings with immediate effect (with future annual increases from this base in line with earnings inflation).
- PRSI receipts are a constant proportion of GNP over time. We were instructed to count 85% of total PRSI receipts as being 'pension-related' (see 7.4 below for details).
- The cost of public service pensions is projected on the basis of the size of the public service remaining constant in absolute terms (rather than, say, a constant proportion of the population).
- Drawdowns from the National Pensions Reserve Fund commence in 2025. Subsequent drawdowns increase from this level in accordance with the growth in the proportion of the population aged over 65.
- Private sector Pillar 2 coverage rates remain constant at their current levels. New entrants to defined benefit schemes are assumed to dry up over the next 20 years (with occupational defined contribution and personal arrangements making up the difference).

7.3 Costs of Pillar 1 pensions

In projecting the costs of Pillar 1 pensions we have worked closely with the Department of Social and Family Affairs in order to ensure that the Pillar 1 projections are consistent with their views on trends in the number of future beneficiaries and their entitlements (see the Pillar 1 assumptions in section 5.7.2 for details).

The approach taken can be summarised as follows. Based on current data, we know the proportion of the population aged 65 and over in receipt of various payments. By making assumptions on how these proportions will move over time, it is possible to calculate the number of recipients under the various payment categories out to 2056, using our population projections. With regard to payment rates, we assume that the contributory old-age pension is indexed to growth in nominal earnings and that the same absolute increases (i.e. in euro amounts) are applied to other payments. Our assumed values for nominal earnings growth are derived in turn from the assumptions on productivity growth and inflation, both of which are discussed in section 6.7 on GNP projections.

The detailed assumptions regarding the proportion of the population in receipt of various benefits are set out in Table 5.1. Some of the more important assumptions include:

- The proportion of males age 65 and over who qualify for a full contributory pension is assumed to rise from the current level of 41.7% to 80% over the period to 2056. The corresponding increase for females is from 11.7% to 57.0%. These increases capture, inter alia, the increasing levels of female participation and the increasing numbers of public servants covered by the PRSI system.
- The proportion of the over-65 population in receipt of non-contributory pensions is assumed to fall from the current level (19.1% of men; 20.3% of women) to 2% by 2056.
- The percentage of the over-65 population receiving no social welfare benefits is assumed to fall to 2% by 2056.

In our projections, we have included the following: contributory and retirement pensions, widow(er)s' contributory and non-contributory pensions, invalidity payments to people aged 65 and over and some other miscellaneous payments to people aged 65 and over. We have not included free schemes or administrative costs.

Our projections are based on the contributory pension being 34% of the previous year's gross average industrial earnings in 2006. The resulting total spend as a percentage of GNP out to 2056 is shown in Table 7.1 for each of the three population scenarios. Looking first at the central scenario, the familiar fiscal problems associated with population ageing can be seen with pension spending rising dramatically as a percentage of GNP. The higher immigration scenario shows how higher inward migration will alleviate the pressure to some degree (but will not solve the problem of increasing cost). Finally, the scenario with longer life expectancy shows an even heavier pension burden in 2056.

Table 7.1: Spending on Pillar 1 pensions as % of GNP, 2006 to 2056, with OACP equal to 34% of GAIE

	2006	2016	2026	2036	2046	2056
Central scenario	3.0	3.7	4.9	6.5	8.7	10.1
Higher immigration	3.0	3.5	4.6	5.9	7.7	9.1
Increased longevity	3.0	3.7	4.9	6.5	8.8	10.5

7.4 Revenues to the State from PRSI

In deciding how to go about projecting PRSI receipts, we discussed the issue with officials in the Social and Family Affairs Vote of the Department of Finance. A high-level analysis of the trends in PRSI receipts and GNP between 1996 and 2005 was undertaken which showed the two growing at essentially identical rates over that period. Given this observation, we decided to simply hold social insurance contributions at a constant rate of 4.3% of GNP over the projection period. The 4.3% value is the average proportion for the years between 1996 and 2005, where the range was no more than plus or minus 0.1% of GNP.

As a further check, we examined the projections of PRSI contribution income undertaken in 2001 as part of the actuarial review of the Social Insurance Fund. The assumptions underlying those projections do not correspond exactly with our assumptions, which makes a direct comparison difficult, but we take comfort from the fact that they project PRSI revenues which are a similar proportion of GNP to our 4.3% assumption.

However, PRSI contributions are used to finance more than just pensions (the aforementioned actuarial review did not attempt to hypothecate contributions to different benefits, but it did provide an analysis of the projected expenditure by benefit type). It projected that pension expenditure as a proportion of total social expenditure would rise from roughly 70% in 2006 to approximately 85% in 2056. On the instructions of the executive of the Pensions Board we have included 85% of all PRSI revenues in our assessment of the net cost to the Exchequer of providing Pillar 1 pensions. (It should be noted that this assumption, whilst impacting the cost of the current system, does not affect the comparison of alternative systems, as the treatment is common to all and thus cancels out when examining the relativities between alternative systems.)

7.5 Costs of public service Pillar 2 pensions

In 2004, total outgo on public service occupational pensions amounted to €1.7 billion; this figure covers payment of pensions, lump sums and spouses' pensions to all public service pensioners. The projection of future outgo, expressed as a percentage of GNP, is set out in Table 7.2 below.

The projections, carried out by the Department of Finance, are based on an update of the detailed projections carried out by the Commission on Public Service Pensions²¹.

In most cases the projections are based, either directly or indirectly, on the large number of assumptions used by the Commission in relation to withdrawals, age and ill retirement pattern and career increase for the various public sector bodies.

The main changes in methodology and assumptions from those used by the Commission are as follows:

- The mortality assumption has been updated to be broadly consistent with the mortality rates underlying our demographic projections (as set out in Chapter 6).
- Social Welfare pensions are assumed to increase in line with public service pay.
- Public service employment numbers are assumed to remain constant at the current level of approximately 280,000 (as measured on a full-time equivalent basis).
- An allowance has been made for changing patterns of recruitment (i.e. a move towards somewhat older recruits) in recent years.
- An allowance has been made for the changes which were made in 2004 to the pension terms for new recruits.

21 Commission on Public Service Pensions (2000), *Final Report*

The figures in Table 7.2 indicate that expenditure is projected to rise steadily over the next 25 years or so – to double by about 2020 and to increase by a factor of close to 3 by 2030. Thereafter, costs continue to increase, but at a slower rate, and it is possible that they may begin to fall in the very long-term (i.e. post-2056) reflecting the full effect of integration and the benefit reductions made in 2004.

Table 7.2: Public service pensions – projected costs to 2056 as % of GNP

	2006	2016	2026	2036	2046	2056
Projected cost as % of GNP	1.3	2.1	2.8	3.3	3.6	3.7

It is worth reiterating that these projected costs have been calculated on an assumption of no growth in public sector employment (i.e. that the size of the public service stays at a constant 280,000 people).

If, on the other hand, we assume that the size of the public sector will remain a constant proportion of the total population over time, this would lead to the following projection of public sector employment (on the basis of the central demographic assumptions):

Table 7.3: Assumed public sector employment numbers if a constant % of population (central demographic scenario)

	2006	2016	2026	2036	2046	2056
Public sector employment (000s)	284	317	335	348	358	360

Thus, if we assume that the public service will continue to represent the same proportion of the total population over time as is currently the case, we see public sector employment numbers rising gradually over the period to 2056, with 29% more public sector employees in 2056 than at present.

On this basis, it is arguable that the public service pension costs quoted in Table 7.2 may understate the position somewhat. Against that, however, it must be borne in mind that any future increase in public service numbers will have little effect for around 40 years (on the basis of recruitment in mid-20s and a minimum pension age for standard public servants of 65). It should also be noted that an assumption that public sector employment remains a constant percentage of the population implies that the public sector will account for an increasing percentage of the labour force as the population ages.

On balance, therefore, we feel no need to amend the public service pension projections provided by the Department of Finance.

Finally, there are a couple of other points which need to be borne in mind when considering the cost of public service pensions. Firstly, no allowance has been made in our figures for future contributions from public servants. No updated projections of contributions were available to us, but we note from the projections undertaken by the Commission in 2000 that the level of contribution income was projected to remain stable over time at approximately 0.25% of GNP. Secondly, our figures for the cost of public service pensions in Table 7.13 below (and subsequent similar tables) differ from those quoted in Table 7.2 above as they allow for the future tax revenues which will flow to the Exchequer from taxing public service pensions as income as they are received.

7.6 National Pensions Reserve Fund

In projecting the development of the National Pensions Reserve Fund, our starting point was the value of the fund as at 31 December 2004. We then rolled the fund forward, allowing for annual contributions throughout the entire projection period of 1% of our projected GNP figures and assuming a real investment return of 4.6% p.a. (see section 6.8.3 for details on the derivation of this rate).

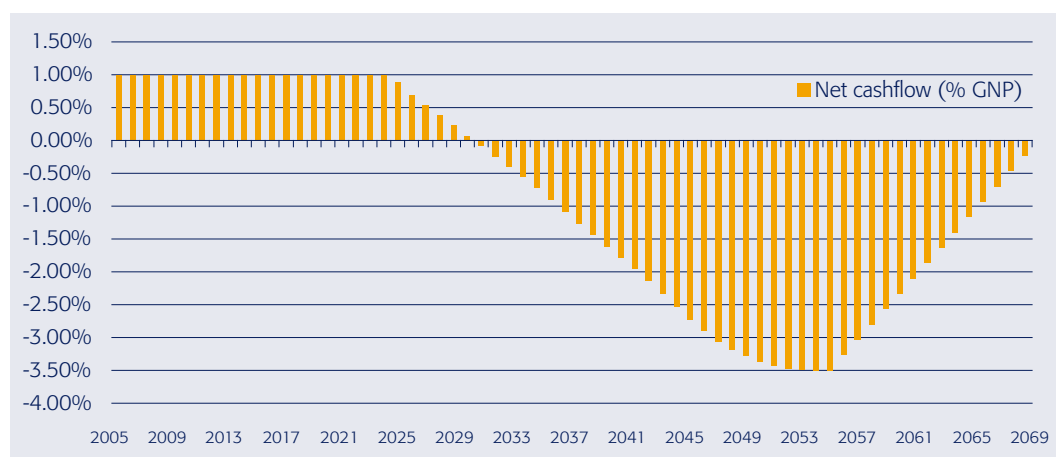
On the basis of our assumptions for future investment returns and GNP growth, we projected that the NPRF would grow to some €138 billion by 2025, or approximately 37% of GNP.

We assumed that the first withdrawal from the fund would be in 2025 (as specified by legislation) and that subsequent drawdowns would increase from the initial level in accordance with the growth in the over-65 population from the 2025 level. This is one possible interpretation of the (somewhat flexible) legislative provisions which govern how and when monies may be taken from the fund. Other assumptions or interpretations are possible, but in the absence of any detailed rules regarding the precise pattern of future drawdowns, we feel that this is a reasonable approach for the purposes of our work. We discussed these issues with officials in the NTMA and they confirmed that they were happy with our proposed methodology and assumptions. Our approach should not be regarded as a policy recommendation, merely one of many possible approaches.

The level of withdrawal in 2025 was set at a level whereby the application of our formula resulted in gross annual withdrawals increasing over the period to 2055, peaking at 4.5% in that year (or 3.5% net of the 1% contribution).

Figure 7.1 sets out the pattern of net cashflows (i.e. contributions less withdrawals, but ignoring investment earnings) on the central demographic scenario. As can be seen, the net drawdown peaks at 3.5% of GNP in the late 2050s.

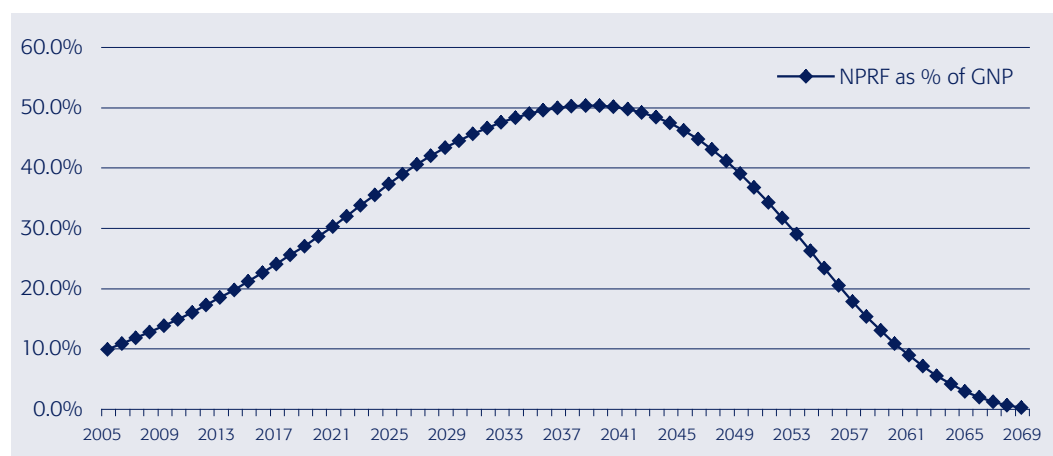
Figure 7.1: National Pensions Reserve Fund: projected net cashflows (central demographic scenario)



Extrapolating GNP out to 2070, our projections indicate that the net drawdowns could be scaled back in an orderly fashion from the 3.5% peak in the mid 2050s, such that the fund would be completely exhausted by 2070. The projections for the two alternative demographic scenarios show a broadly similar picture.

Based on the assumed pattern of inflows and drawdowns as described above, and assuming real investment returns of 4.6% p.a., the NPRF is projected to develop as set out in Figure 7.2.

Figure 7.2: National Pensions Reserve Fund: projected fund size (% of GNP; central scenario)



It is important to note that projections of the size of the NPRF (and hence of how much the NPRF can deliver) are extremely sensitive to the real rate of return which is assumed to be earned on the assets of the fund. For example, reducing the assumed real rate of return by 1 percentage point (from 4.6% to 3.6% p.a.) would restrict the peak drawdown in 2055 to 2.6% of GNP (as opposed to 3.5% of GNP on the central assumption).

Table 7.4 shows the maximum drawdowns which could be taken on a range of assumptions for the real rate of return. In each case, the drawdowns are calculated so as to peak in 2055, scaling back to almost nil in 2070 and such that the fund is exhausted in 2070.

Table 7.4: NPRF: Comparison of possible drawdowns on alternative real return assumptions

	2036	2046	2056	2066
Assuming 5.6% p.a. real return	1.4%	3.7%	4.7%	1.6%
Assuming 4.6% p.a. real return (central)	0.9%	2.7%	3.5%	1.2%
Assuming 3.6% p.a. real return	0.5%	2.0%	2.6%	0.9%

Throughout the remainder of this report, in determining the net Exchequer cost of the various systems, we have used NPRF figures which have been calculated on our central assumption for the real rate of investment return of 4.6% per annum. It should be noted that the actual net Exchequer cost will, therefore, be quite sensitive to the actual investment return earned on the NPRF.²²

7.7 Private sector Pillar 2 arrangements

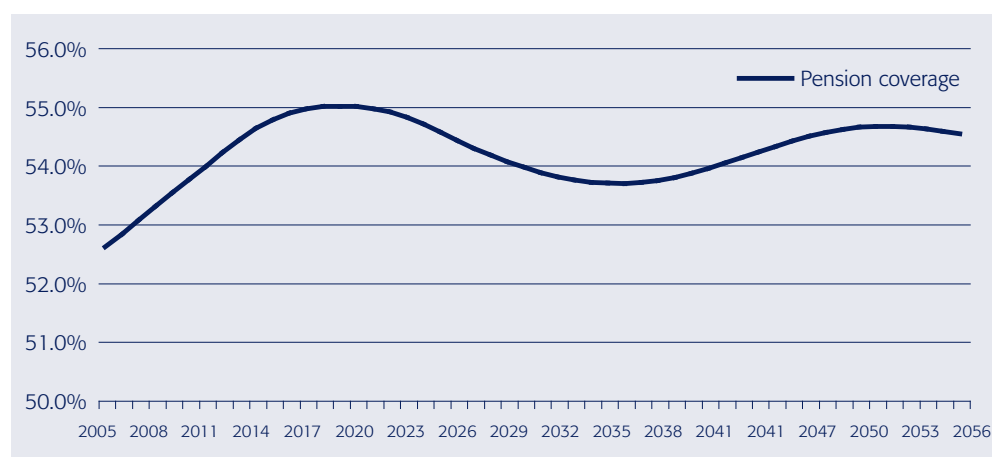
The following sections describe the approach we took to modelling the evolution of the current private sector Pillar 2 pension arrangements. This is a complex exercise which involves projecting membership numbers, contributions, assets and benefits in order to determine the net cost to the Exchequer of providing tax reliefs on contributions and investment earnings.

22 However, as the NPRF is common to all systems, the cost relativities between the various systems are independent of whatever approach is adopted in respect of the NPRF.

7.7.1 Membership

We assumed that the age-specific pension coverage rates remain constant at their current levels (as per the most recent CSO coverage survey). This means that, as the age mix of the labour force varies over time, so too does the overall coverage rate for the labour force as a whole. The progression in the overall coverage rate, which varies over time in a relatively narrow band between 53% and 55%, is shown in Figure 7.3.

Figure 7.3: Overall pension coverage rate



Based on these coverage rates, and allowing for public servants, we were able to derive projected numbers of private sector employees with pension arrangements and hence the private sector coverage rates.

These numbers are summarised in Table 7.5.

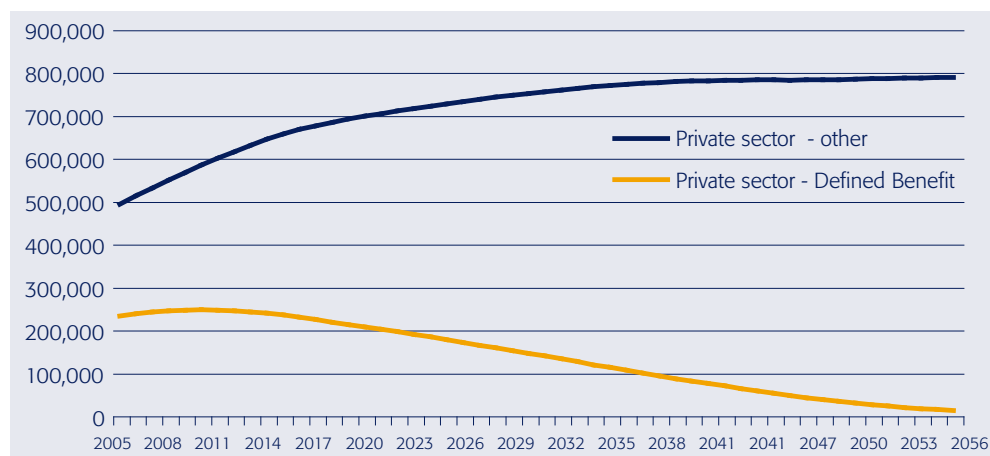
Table 7.5: Projected numbers of private sector employees with pension arrangements 2006-2056

	2006	2016	2026	2036	2046	2056
Private sector employees aged 18-64 (000s)	1,647	1,842	1,871	1,855	1,737	1,681
Of which, those with pension arrangements	745	892	898	873	824	795
Private sector pension coverage	45.2%	48.4%	48.0%	47.1%	47.4%	47.3%

We then further subdivided the private sector employees between those who were members of defined benefit schemes, those who were members of defined contribution schemes and those who had personal pension arrangements. This was done on the assumption that new entrants to private sector defined benefit schemes would gradually dry up over the next twenty years.

The resulting projected membership numbers are as illustrated in Figure 7.4.

Figure 7.4: Projected membership of private sector pension arrangements



Finally, having determined the projected total numbers in each type of pension arrangement, we segmented the total membership by age and income, using information from the CSO survey of pensions coverage (age) and the National Pension Policy Initiative report²³ (income).

7.7.2 Contributions

The analysis of the labour force by earnings band was applied to the projected private sector membership numbers, to give the number of contributors in each wage band and their estimated total earnings. The relevant contribution rates were then applied to the total earnings of each group in order to estimate the contribution income.

Employee contributions

For defined contribution occupational schemes we assumed a standard contribution of 5% of earnings. For defined benefit schemes we assumed a standard contribution of 4% of pensionable earnings (where pensionable earnings allow for the effect of integration with the OACP) across the board. These assumptions were based on an analysis of recent benefit surveys. The lower assumed average contribution rate for defined benefit schemes reflects the fact that there are more defined benefit non-contributory schemes. For personal arrangements (RACs/PRSAs), we assumed a standard contribution rate of 10% of earnings.

In all cases we made an allowance for additional voluntary contributions (AVCs) at higher ages and in the higher earnings bands, using the CSO survey results as a guide.

Employer contributions

For defined contribution occupational schemes we assumed a standard contribution of 5%, based on the findings of a recent benefit survey. For defined benefit schemes we determined the contribution rate required to meet the 'balance of cost' based on current assets and assuming that employers are funding for an average benefit (based on an assumed average number of years of service, level of spouses pension, indexation rate etc.). Our assumptions in relation to average benefits were taken from the IAPF survey²⁴ of DB scheme benefits.

We calculated the required employer contribution rate taking into account that some schemes are currently paying extra contributions to address deficits. Allowing for this, we arrived at an employer contribution rate of 16.9% payable for the next five years and 15.0% payable thereafter.

For personal arrangements (RACs/PRSAs), we assumed that there were no employer contributions.

²³ The Pensions Board (1998), *Securing Retirement Income*, Appendix J

²⁴ Irish Association of Pension Funds (2002), *IAPF Benefits Survey 2002*

Total contributions

The following table illustrates the evolution of contribution income over the period 2006 to 2056.

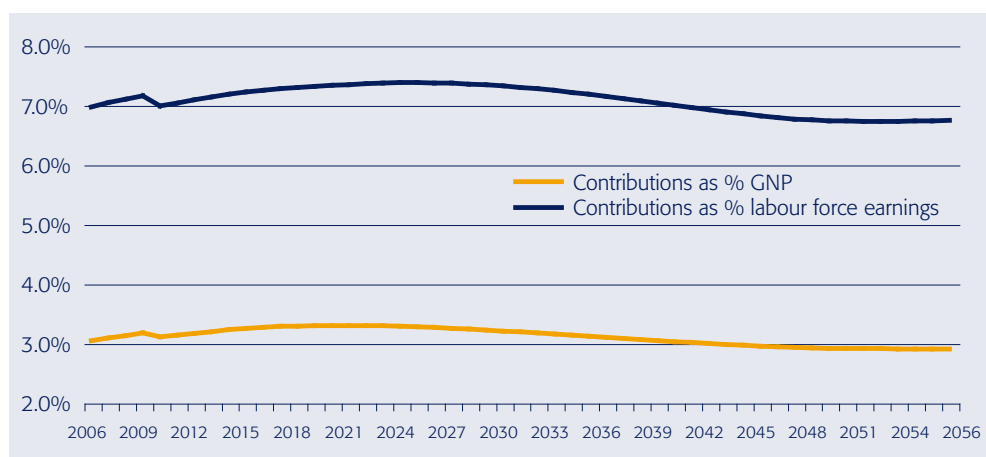
Table 7.6: Private sector Pillar 2 contributions 2006-2056 (€m, 2006 prices)

	2006	2016	2026	2036	2046	2056
DC – employers	495	1,078	1,561	2,027	2,630	3,322
DC – employees*	2,004	3,382	4,735	6,046	7,195	8,977
DB – employers	1,296	1,451	1,337	968	475	118
DB – employees	479	643	656	547	299	79
Total	4,274	6,554	8,288	9,588	10,598	12,496

* includes personal pension arrangements

Figure 7.5 illustrates the progression of total contributions over time, both as a percentage of GNP and as a percentage of labour force earnings.

Figure 7.5: Private sector Pillar 2 contributions 2006-2056



The graph shows a gradual downward trend reflecting the declining importance of defined benefit schemes (which typically have higher total contribution rates).

7.7.3 Tax Relief on Contributions

In order to determine the cost of tax (and PRSI) relief on employee contributions, we calculated an appropriate marginal tax rate and PRSI rate for each earnings band and applied these to the total contributions paid by the members in each band. We also allowed for the employer PRSI relief on employee contributions. Employer contributions were given tax relief at the corporation tax rate. We assumed no changes to tax or PRSI rates over time.

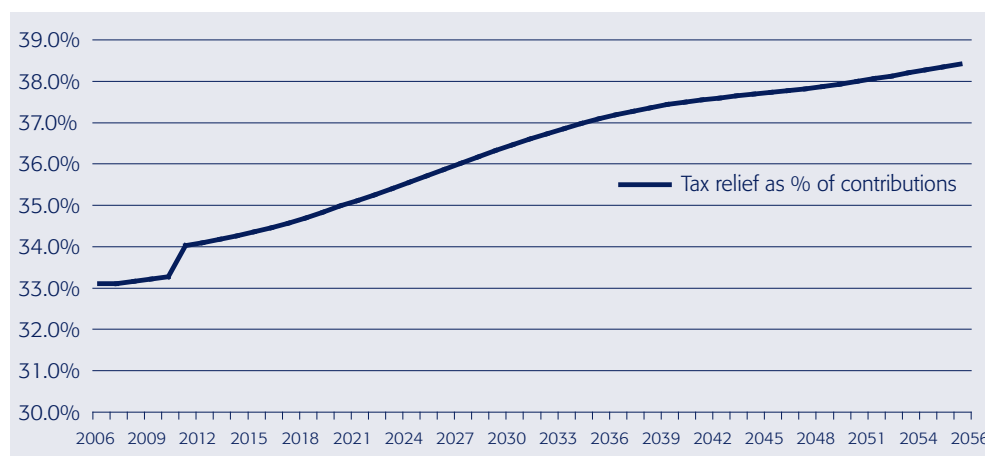
Table 7.7 summarises the projected amount of tax (& PRSI) relief on private sector Pillar 2 contributions. The projections indicate a fairly constant cost over the period to 2056.

Table 7.7: Relief on private sector Pillar 2 contributions 2006-2056 (€m, 2006 prices)

	2006	2016	2026	2036	2046	2056
Private sector contributions	4,274	6,554	8,288	9,588	10,598	12,496
Tax relief	1,413	2,263	2,981	3,569	4,002	4,802
Tax relief as % of GNP	1.0%	1.1%	1.2%	1.1%	1.1%	1.1%

Figure 7.6 illustrates the development of the average rate of tax & PRSI relief over time.

Figure 7.6: Private sector Pillar 2 average rate of tax & PRSI relief on contributions



The average rate trends upwards over time as employee contributions (which attract higher rates of relief than employer contributions) become an increasing proportion of total contributions. Once again, this reflects the declining importance of defined benefit schemes (where employers typically pay a higher proportion of the total cost).

7.7.4 Expenses

In projecting the progression of pension fund assets over time, we need to make allowance for the explicit costs of selling, processing and administering pension products, and the explicit charges paid to fund managers (direct trading costs have already been factored in to the investment return assumption).

The level of such costs are generally significantly higher for people purchasing personal pensions on an individual basis than for people gaining the benefits of employer bulk purchasing via occupational schemes or group personal pension arrangements. Standard PRSAs have a price cap on the amount which can be charged for explicit costs (but non-standard PRSAs have no such price cap).

For personal pensions (RACs) and PRSAs, current regulations oblige the institution providing the pension to disclose the effect of explicit costs in the documentation which is provided to prospective clients at the point of sale. The total impact of these explicit costs is captured and expressed as the “effect of charges” or “reduction in yield” (RIY).

A typical RIY for a standard PRSA, assuming a 35-year term, is 1.3%. Personal pensions (and non-standard PRSAs) currently being sold are likely on average to have similar, but perhaps slightly higher, RIYs. Existing personal pensions which pre-date the introduction of PRSAs are likely on average to have still higher RIYs. On balance, therefore, we propose to assume an average prospective reduction in yield of 1.5% p.a. for RACs and PRSAs.

The available data on employer-sponsored pension schemes is more limited (due to the absence of required regulatory disclosure). It seems clear, however, that members of occupational schemes benefit both from economies of scale and from cheaper product pricing.

A survey of administrative costs in the UK carried out by the Government Actuary's Department in 1995 suggested total costs of about 0.5% for what it termed "small occupational schemes" (less than 1,000 members). However, on the basis that there are very few occupational schemes in Ireland with more than 1,000 members (indeed the vast majority have less than 100 members) and that the Irish market is likely to be somewhat less competitive than the UK, an assumption closer to the RAC/PRSA level seems reasonable. Indeed in the course of the UK review of the stakeholder price cap, some commentators suggested that an RIY of 1.5% would be required to make sales to an employee in a 25 employee company profitable, even when the employer makes a contribution.

On that basis, and in the interests of simplicity, we have made the same RIY assumption for occupational schemes as for RACs/PRSAs (1.5%). This will tend to overstate the explicit costs for members of the larger schemes, but given the nature of the Irish labour force, we do not feel that this is a significant issue.

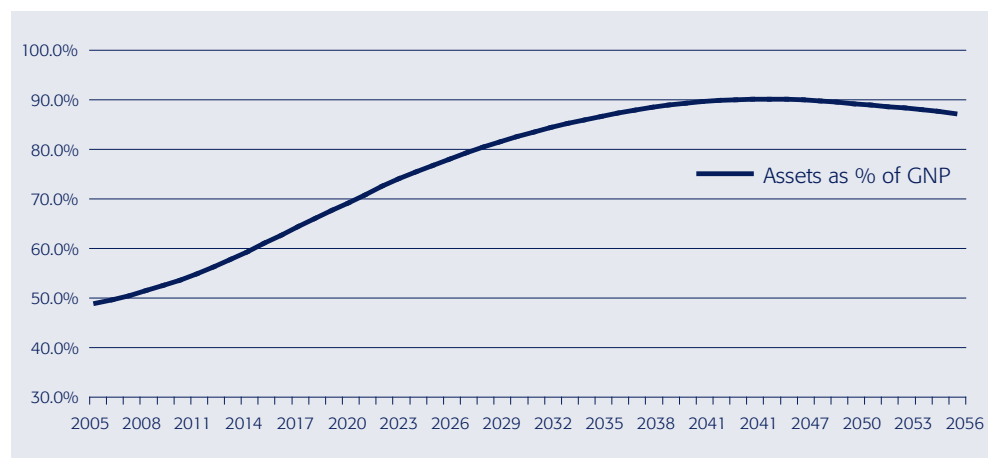
In the post-retirement phase we assume once-off expenses of 3% of the fund prior to annuitisation (reflecting typical annuity commission rates of 2% plus an assumed profit margin of 1%).

7.7.5 Assets

Our projection of Pillar 2 pension fund assets took as its starting point the estimated total value of assets currently held by defined benefit, defined contribution and personal pension arrangements. These total assets were then apportioned across the current membership to give the opening position. The opening assets were then rolled forward allowing for changes in membership, contributions received, benefits paid, expenses and investment returns.

As can be seen from Figure 7.7, the size of private sector Pillar 2 assets (expressed as a percentage of GNP) is projected to grow from its current level of close to 50%, peaking at approximately 90% in the mid-2040s, before falling back slightly by 2056.

Figure 7.7: Growth in private sector Pillar 2 assets as % of GNP, 2006-2056



7.7.6 Tax relief on investment income & gains

Based on the projected investment earnings on the assets in 7.7.5, we calculated the tax foregone by the Exchequer from not taxing those investment earnings. In deriving this cost we assumed that, were they not tax exempt, pension fund investment earnings would be taxed at 20% each year.

This rate is consistent with the rates of tax currently levied on deposit interest (20%) and on life assurance investment products (23%, comprising a basic 20% plus an additional 3% to allow for the effect of deferment, as life policy investments are taxed on maturity rather than on a year-by-year basis).

Table 7.8: Private sector Pillar 2 investment income & gains 2006-2056 (€m, 2006 prices)

	2006	2016	2026	2036	2046	2056
Investment income & gains	2,825	4,954	7,853	10,766	12,987	15,013
Tax relief at 20%	565	991	1,571	2,153	2,597	3,003
Tax relief as % of GNP	0.4%	0.5%	0.6%	0.7%	0.7%	0.7%

In arriving at the net Exchequer cost of the current system (see 7.8 below), we include the “cost” of this tax foregone. It is open to debate as to whether this is a real cost (i.e. should it really be thought of in the same terms as the cost of providing tax relief on contributions?). Whatever about the current system, it seems somewhat strange to consider it a cost in the case of those alternative systems which involve mandatory contributions (Alternative Systems 2 and 3 in particular).

7.7.7 Benefit payments

Our first task was to determine the total amount of private-sector pensions currently in payment. We did this as follows:

- Firstly, we added up the total pensions in payment as reported in life assurance companies’ regulatory filings with the Financial Regulator. This gave us a figure for the total amount of insured pensions in payment.
- We then used data provided by one of the largest life assurance companies to apportion this total amount by age (we assumed that the company’s data was representative of the market as a whole).
- We then used data gathered by the Society of Actuaries in Ireland (for use in an investigation into pensioner mortality) to provide us with similar data for non-insured pensions in payment. We needed to adjust the Society’s data to remove public service pensioners and to make some allowance for the fact that the Society’s data did not cover all private sector schemes.
- Information on assets held in Approved Retirement Funds (ARFs) was also required. This was taken from the life company regulatory filings referred to above. This total figure was then adjusted to reflect the fact that there are also ARF assets which are held by other types of financial institutions (but on which data is not available). We also made suitable assumptions about the age distribution of ARF holders. For modelling purposes we assumed that ARF assets would be fully drawn down over the remaining lifetime of the ARF holder (i.e. we annuitised the ARF fund).

Having determined the pensions payable in the future to existing pensioners, the next step was to add the pensions payable to future pensioners. These were determined (for both DB and DC pensioners) by projecting their assets at retirement, using the assumptions outlined above regarding contributions, investment returns, take-up of the tax-free lump sum and expenses.

We assumed full take-up of the tax-free lump sum (modelled as 25% of the retirement fund), with the remaining assets converted into a pension using a suitable annuity rate at retirement allowing for mortality, expenses and investment returns as set out above. The projected pension payments are shown in Table 7.9.

Table 7.9: Private sector Pillar 2 pension payments 2006-2056 (€m, 2006 prices)

	2006	2016	2026	2036	2046	2056
Pension payments	1,138	1,822	3,473	6,294	9,915	11,975

7.7.8 Tax revenue on benefit payments

Having determined the projected pension payments in 7.7.7, we then assumed that these would be taxed at 20%, with a further allowance for the 2% health levy, bringing total revenue to the Exchequer of 22% of the pension.

The justification for our choice of 20% as the marginal tax rate lies in the fact that the average pension payment to private-sector pensioners is currently some €8,000 p.a. Private sector pensioners will generally also have additional sources of retirement income (Pillar 1 pensions and Pillar 3 income), but on the other hand we also need to allow for the effect of tax free allowances etc. Overall, therefore, an assumption of 20% is probably not unreasonable.

The average pension is projected to increase over time, so some increase in the assumed tax rate could be justified over time. We decided, however, to hold the tax rate constant at 20% (which is arguably a little on the low side).

Table 7.10 summarises the projected amount of tax (& PRSI) revenue from private sector Pillar 2 pensions in payment.

Table 7.10: Revenue from private sector Pillar 2 pensions in payment 2006-2056 (€m, 2006 prices)

	2006	2016	2026	2036	2046	2056
Private sector pensions	1,138	1,822	3,473	6,294	9,915	11,975
Tax revenue	250	401	764	1,385	2,181	2,635
Tax revenue as % of GNP	0.2%	0.2%	0.3%	0.4%	0.6%	0.6%

7.7.9 Summary of private sector Pillar 2 arrangements

Bringing together all of the elements of the current private sector Pillar 2 pensions system as outlined in 7.7.1 to 7.7.8 above, the revenues and costs to the Exchequer are as set out in Table 7.11.

Table 7.11: Projected net cost of private sector Pillar 2 pensions (% GNP, central scenario)

	2006	2016	2026	2036	2046	2056
Tax relief on contributions	1.0%	1.1%	1.2%	1.1%	1.1%	1.1%
Tax relief on investment income	0.4%	0.5%	0.6%	0.7%	0.7%	0.7%
Tax revenue from pensions	(0.2%)	(0.2%)	(0.3%)	(0.4%)	(0.6%)	(0.6%)
Net cost to the Exchequer	1.2%	1.4%	1.5%	1.4%	1.2%	1.2%

The cost of tax relief on contributions is almost constant over the period to 2056. This is not surprising as contributions are a function of the size of the labour force and the level of earnings, whilst GNP is also projected to grow in line with the labour force and increases in productivity (or earnings).

The cost of tax relief on investment income gradually increases as the size of private-sector pension funds is projected to grow faster than the economy as a whole.

Revenue from pensions also grows over time as the number of pensioners and the average size of pensions both grow over time.

Overall, the net cost of private sector Pillar 2 pensions is projected to rise over the next 20 years from its current level of 1.2% of GNP to 1.5% of GNP in 2026, before falling back to 1.2% of GNP by 2056.

7.8 Summary of direct and indirect Exchequer costs

Taking the figures from the sections above we can project the total gross and net Exchequer costs over the period to 2056.

Looking first at the projected situation on a gross basis, we see a projected increase in pension costs of almost 10 percentage points, from 5.7% of GNP in 2006 to 15.6% in 2056. As can be seen from Table 7.12, the bulk of this increase relates to Pillar 1 pensions, with the cost of public service pensions and the cost of tax reliefs to private sector pensions also increasing over time.

Table 7.12: Projected gross Exchequer costs to 2056 as a % of GNP; central scenario

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	3.0%	3.7%	4.9%	6.5%	8.7%	10.1%
Public service pensions	1.3%	2.1%	2.8%	3.3%	3.6%	3.7%
Tax relief on contributions	1.0%	1.1%	1.2%	1.1%	1.1%	1.1%
Tax relief on investment income	0.4%	0.5%	0.6%	0.7%	0.7%	0.7%
Gross Exchequer cost	5.7%	7.4%	9.5%	11.6%	14.1%	15.6%

The position on a net basis is as summarised in Table 7.13.

Table 7.13: Projected costs and revenues to 2056 as a % of GNP; central scenario

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	3.0%	3.7%	4.9%	6.5%	8.7%	10.1%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions*	1.0%	1.6%	2.2%	2.6%	2.8%	2.9%
NPRF	1.0%	1.0%	0.7%	(0.9%)	(2.7%)	(3.5%)
Tax relief on contributions	1.0%	1.1%	1.2%	1.1%	1.1%	1.1%
Tax relief on investment income	0.4%	0.5%	0.6%	0.7%	0.7%	0.7%
Tax revenue from pensions	(0.2%)	(0.2%)	(0.3%)	(0.4%)	(0.6%)	(0.6%)
Net cost to the Exchequer	2.5%	4.0%	5.6%	5.9%	6.3%	7.0%

* Note: The figures for the net cost of public service pensions in this and subsequent tables are lower than those in Table 7.2 above as the tax revenue from public service pensions has been netted off.

The overall picture is that the net cost of the current pension system is projected to increase by a factor of 2.8 over the period to 2056.

The main driver of this overall increase is the projected increase in the cost of Pillar 1 and public service pensions: taken together, gross expenditure on these items is projected to increase from 4.3% of GNP to 13.8% of GNP over the period in question.

PRSI revenues are stable at 3.7% of GNP (taking 85% of total PRSI revenues) and the NPRF is projected to defray costs by 3.5% of GNP by 2056.

As already highlighted in 7.7.9, the net cost of private sector Pillar 2 pensions (i.e. tax reliefs on contributions and investment returns, less tax revenues from pensions in payment) is projected to remain close to its current level throughout the projection period.

7.9 Results on alternative demographic assumptions

We recalculated the projected net Exchequer costs on the basis of the two alternative demographic hypotheses. The results are set out in Table 7.14 and Table 7.15 below.

7.9.1 Higher immigration

Under the higher immigration scenario, the projected net Exchequer cost of the current system is projected to develop as set out in Table 7.14.

Table 7.14: Projected costs and revenues to 2056 as a % of GNP; higher immigration scenario

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	3.0%	3.5%	4.6%	5.9%	7.7%	9.1%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions	1.0%	1.6%	2.0%	2.3%	2.4%	2.3%
NPRF	1.0%	1.0%	0.7%	(0.6%)	(2.3%)	(3.3%)
Tax relief on contributions	1.0%	1.1%	1.2%	1.2%	1.2%	1.2%
Tax relief on investment income	0.4%	0.5%	0.6%	0.7%	0.7%	0.7%
Tax revenue from pensions	(0.2%)	(0.2%)	(0.3%)	(0.4%)	(0.5%)	(0.6%)
Net cost to the Exchequer	2.5%	3.8%	5.1%	5.4%	5.5%	5.7%

It is worth noting that the overall picture is reasonably similar to the position on the central scenario – the net cost to the Exchequer is projected to increase over time (albeit not as steeply, with the cost in 2056 now projected to be 5.7% rather than 7.0% of GNP). This is an important point to bear in mind as it is sometimes thought that higher immigration could be a panacea for the increasing cost of the current system. Our projections indicate that this is not the case, although it is certainly true that higher immigration is projected to ease the burden.

7.9.2 Increased longevity

Under the increased longevity scenario, the position is projected to worsen post-2036 compared to the central scenario.

Table 7.15: Projected costs and revenues to 2056 as a % of GNP; increased longevity scenario

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	3.0%	3.7%	4.9%	6.5%	8.8%	10.5%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions ²⁵	1.0%	1.6%	2.2%	2.6%	2.8%	2.9%
NPRF	1.0%	1.0%	0.7%	(0.8%)	(2.6%)	(3.6%)
Tax relief on contributions	1.0%	1.1%	1.2%	1.1%	1.1%	1.1%
Tax relief on investment income	0.4%	0.5%	0.6%	0.7%	0.7%	0.7%
Tax revenue from pensions	(0.2%)	(0.2%)	(0.3%)	(0.4%)	(0.6%)	(0.6%)
Net cost to the Exchequer	2.5%	4.0%	5.6%	6.0%	6.5%	7.3%

7.10 Summary

In summary, the net cost to the Exchequer of the current system is projected to increase almost threefold over the period to 2056, from a current cost of 2.5% of GNP to 7.0% of GNP. The main driver of this overall increase is the projected increase in the cost of Pillar 1 and public service pensions.

The projections allowing for higher immigration show a somewhat better picture – in this case the net cost is projected to increase to 5.7% of GNP by 2056. The third demographic scenario (greater improvements in longevity post-2036) gives results which are similar to, but slightly worse than, those on the central scenario.

On the basis of these findings, it seems fair to comment that there are some issues with the sustainability of the current system. Bear in mind that the projections have been carried out on an “as is” basis. In other words, Pillar 2 coverage is assumed to remain static and no benefit improvements (other than up-rating in line with earnings) have been assumed.

We have not been asked to provide suggestions for potential solutions to the problem of the increasing cost of the current pensions system, but it seems to us that a number of approaches are possible (none of which is particularly attractive). These include:

- Linking future increases in the flat-rate Pillar 1 pension to prices rather than earnings. This has the advantage of cutting the cost of Pillar 1 pensions quite considerably in the long-term, but at the expense of eroding the value of the pension as a proportion of average earnings.
- Means-testing Pillar 1 flat-rate benefits. Whilst theoretically possible, this is unlikely to be acceptable from a political/societal standpoint.
- Increasing PRSI contributions to meet the rising cost of the Pillar 1 pension.
- Increasing the retirement age.
- Increasing contributions to the National Pensions Reserve Fund in order to pre-fund a greater proportion of the future bill and hence smooth the cost over time. This suffers from the drawback that the State’s commitment to the NPRF is already considerable (at 1% p.a. of GNP). Nevertheless, it may be a more palatable solution than the others.

²⁵ Note that we did not have sufficient information to allow us to adjust the post-2036 public service pension costs to reflect the effect of the assumed improvement in longevity. The figures in Table 7.15 for 2046 and 2056 are slightly understated, therefore.

8 Qualitative assessment of current system

8.1 Introduction

As well as examining the projected net Exchequer costs and sustainability of the five alternative systems, we have also been asked to evaluate them qualitatively from the following standpoints:

- economic/competitiveness/employment impacts;
- inter-generational equity;
- intra-generational (re)distributive effects;
- likely administration costs and efficiency in comparison with the current pension arrangements and in comparison with other systems;
- the relative merits of funding versus pay as you go; and
- effect on the national savings rate.

Before assessing each of the alternative systems, it would be useful firstly to examine the current system against these criteria, where relevant.

8.2 Inter-generational equity

Under the current system, inter-generational equity is only really an issue for Pillar 1 and public sector Pillar 2 pensions (both of which are on a pay-as-you-go basis). All private sector Pillar 2 arrangements are managed on a funded basis. The issue, therefore, revolves around the question of whether or not to fund the pay-as-you-go elements (see comments in 8.5 below).

8.3 Intra-generational (re)distributive effects

The current Pillar 1 system is, by its nature, a redistributive system with higher earners receiving lower pension benefits (as a proportion of their contributions) than the lower paid. Table 8.1 illustrates the position (on the basis of certain assumptions)²⁶ for those paying full-rate social insurance contributions.

Table 8.1: Value for money index of social insurance claims in retirement (ratio of lifetime benefits to contributions)

	Earnings level (as multiple of gross average industrial earnings)			
	0.5 x GAIE	1.0 x GAIE	2.0 x GAIE	3.0 x GAIE
Single male	3.55	1.41	0.74	0.53
Couple	8.10	3.22	1.69	1.20
Single female	4.82	1.92	1.01	0.71

Note: A value for money index of 1.00 indicates breakeven.

Source: Department of Social and Family Affairs (2005)

²⁶ See Department of Social and Family Affairs (2005), *Ireland's National Strategy Report to the European Commission on Adequate and Sustainable Pensions*, p. 24

For the current Pillar 2 system, the main issue under this heading relates to the unevenness of pension coverage and hence the uneven distribution of tax benefits. The current tax treatment of Pillar 2 pensions could be criticised as inequitable, as high earners receive disproportionate tax benefits.

There are two main reasons for the regressivity of tax expenditure on private pensions. The first is that membership of occupational pension schemes increases strongly with income. The second is that the tax relief is given at the marginal rate of tax. Hence, the value of the tax relief as a percentage of income rises as income rises. The interaction of these two factors results in a steady increase in the absolute value of the tax relief on occupational pension contributions as the absolute value of income rises. Studies²⁷ of the current Irish system have shown that the top 10% of earners receive 40% of the tax benefits, with the other 60% going to middle income earners.

8.4 Administration costs and efficiency

Figures for the level of administrative costs of the different components of the current pension system are difficult to come by.

- According to the actuarial review of the Social Insurance Fund published in 2002, the social insurance fund had annual running costs of approximately 4% of contributions in 2000.
- Standard PRSAs have charges of 5% of contributions and 1% p.a. of fund value. Over a 35-year term this is equivalent to a charge of 1.3% p.a. on the fund value alone.
- Non-standard PRSAs and other personal pension arrangements are likely to have higher charges than standard PRSAs.
- The available data on employer-sponsored pension schemes is more limited. It seems clear, however, that members of occupational schemes benefit both from economies of scale and from cheaper product pricing so that the effect of expenses is likely to be somewhat lower than for standard PRSAs on average (probably ranging from 0.5% to 1.5% p.a. for all but the very largest schemes).

It is difficult to draw any meaningful conclusions about the relative efficiency of the various components of the current pension system. It is interesting to note however that standard Irish PRSA charges (1.3% p.a. for a 35-year contract) are somewhat higher than their UK stakeholder pension counterparts (1.0% p.a.).

8.5 The relative merits of funding versus pay as you go

The big disadvantage of PAYG in an ageing population is the implicit need to raise contributions if benefit levels are to be maintained. If one were introducing a pension system from scratch and knew that the population was ageing one would probably opt for a funded approach.

The difficulty arises when, as with the current Irish system, you already have a PAYG system and you want to consider moving to a funded model. In this situation current employees are essentially being asked to pay twice – to fund their own pensions and to pay the pensions of today's retirees. Hence the big disadvantage of a move from PAYG to funded is the intergenerational inequity issue.

The choice then boils down to who will take the hit – today's employees if you move to a funded system or tomorrow's if you stay with PAYG. In reality this is a political/societal choice about which economics can say little.

More generally, as set out in section 5.2.6, funding brings a financial transparency and discipline which is normally lacking under a pay-as-you-go system.

27 Hughes et al (2004), *Reforming Pensions in Europe*

Some of the other arguments about the relative merits of funding versus PAYG relate to the potential impact on national savings. It might be argued that a funded system raises savings and hence investment. If this raises the productive capacity of the economy, then perhaps funding is preferable. As outlined in section 10.10, however, it is not axiomatic that funding leads to increased saving.

8.6 National savings rate

When assessing alternative pension systems in later chapters, one of the issues to be considered is the potential impact on the national savings rate. In order to place those discussions in context, we felt it would be helpful to summarise the current position.

The historical evolution of the personal savings rate (personal savings as a proportion of personal disposable income) is set out in Table 8.2.

Table 8.2: Personal savings rate (as % of disposable income), 1990-2004

Year	Average personal savings rate
1990 – 1994	9.1%
1995 – 1999	9.1%
2000 – 2004	10.4%
2005	11.5%

Source: Figures for 1990 to 2003 are from the CSO's National Income and Expenditure releases; figures for 2004 and 2005 are projected values from the ESRI's Quarterly Economic Commentary.

As can be seen from the table, the personal savings rate is currently higher than the average rate for the last decade and a half. The recent upward drift can be explained by strong earnings growth without a proportionate rise in consumption.

We felt it would also be useful to attempt to put Ireland's savings rate in an international context. Unfortunately, we were unable to locate data for a range of countries on household savings. Instead, we needed to use Eurostat data on national savings, which include the government, households and business. Table 8.3 sets out the Eurostat data.

Table 8.3: Net national savings (as a % of GDP) for selected EU countries, 2005

Country	National savings rate
Belgium	8.0
Denmark	7.5
France	6.6
Germany	6.5
Ireland	11.8
Italy	6.0
Netherlands	8.9
Spain	7.5

In looking at Table 8.3, a number of points should be kept in mind. Whereas Table 8.2 looked at personal savings and personal disposable income, the savings rates in Table 8.3 are defined differently: the savings figure is “national” which means, as noted above, that it includes private and public sector saving; the denominator of the rate is GDP as opposed to personal disposable income. These are important points because public saving in Ireland is higher than elsewhere due largely to the funding of infrastructural developments. For example, in 2001, public saving in Ireland was equal to about 5.5% of GDP; for the EU-15, the figure was 2.1%.

Keeping these points in mind, we can conclude from Table 8.3 that there is no evidence of a national savings “shortfall” relative to their countries – if we subtract the extra public saving relative to other countries, Ireland’s private-sector savings compare with those elsewhere. It is possible that the split of private-sector savings between household and business savings differ, but the data do not allow us to differentiate.

8.7 Summary

In summary, the current system is open to criticism in terms of the uneven distribution of Pillar 2 tax benefits and, arguably, the level of costs. The question of prefunding Pillar 1 and public service Pillar 2 pensions also needs to be addressed, which brings implications for inter-generational equity.

9 Assessment of Alternative System 1

9.1 Introduction

As outlined in section 4.2, this system is essentially a continuation of the current Irish pension system, but with enhanced tax relief for lower earning contributors to Pillar 2 arrangements (relief at 42% for all contributors) and with a cap on tax relief for higher earning contributors.

9.2 Methodology and assumptions

The methodology and assumptions used to assess this system are as set out in Chapters 5, 6 and 7. They are the same as those used in assessing the current system, with the following exceptions:

- Coverage rates: We assumed that coverage rates in the second lowest and middle income bands would increase by 10 percentage points over the next 10 years. (We ignored the lowest band because of affordability issues.) As noted earlier, this is not a prediction, merely a mechanism for exploring the impact of increased participation amongst the lower income groups.
- Tax relief on contributions: We used a 42% tax rate (plus an allowance for PRSI as before), rather than the marginal tax rate.

9.3 Direct and indirect Exchequer costs

On this basis, the projected net cost to the Exchequer is as set out in Table 9.1.

Table 9.1: System 1: Projected costs and revenues to 2056 as a % of GNP; central scenario

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	3.0%	3.7%	4.9%	6.5%	8.7%	10.1%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions	1.0%	1.6%	2.2%	2.6%	2.8%	2.9%
NPRF	1.0%	1.0%	0.7%	(0.9%)	(2.7%)	(3.5%)
Tax relief on contributions	1.1%	1.3%	1.4%	1.3%	1.3%	1.3%
Tax relief on investment income	0.4%	0.5%	0.6%	0.7%	0.8%	0.7%
Tax revenue from pensions	(0.2%)	(0.2%)	(0.3%)	(0.5%)	(0.6%)	(0.6%)
Net cost to the Exchequer	2.6%	4.2%	5.8%	6.0%	6.6%	7.2%
Increase vs. current system	0.1%	0.2%	0.2%	0.1%	0.3%	0.2%

As can be seen from the Table, the net cost to the Exchequer is projected to be slightly higher under this system than for the current system. This reflects our assumption of increased Pillar 2 participation in response to the enhanced tax incentives for basic rate taxpayers as well as the fact that all contributions now attract relief at 42%.

One feature of this system is the proposal to limit the tax reliefs available to very high earners. This proposal will help to offset the additional cost of providing tax relief to lower earners. It should be noted, however, that (as agreed with the executive of the Pensions Board) our quantitative projections of the net Exchequer cost of this system make no allowance for the potential financial impact of these proposed curbs.

The results on the basis of the alternative assumptions for mortality and migration are set out in Appendix B.

9.4 Sustainability

On the question of sustainability, the comments for this system largely mirror those for the current system. As can be seen, this system suffers from the same problems (but has the added burden of higher tax relief on contributions) and is projected to be marginally more expensive than the current system.

9.5 Other criteria

As this system is essentially a continuation of the current system, with the only change being to the tax incentives for voluntary Pillar 2 provision, the issues which arise with this system in relation to various criteria such as economic impacts, inter-generational equity etc. are largely as set out in Chapter 8 for the current system.

The only change relates to the change in the rules for tax relief on contributions. Providing relief at the same rate for all and capping the amount of relief available should serve to address the regressivity in the current system (as outlined in section 8.3 above).

9.6 Summary

This system involves relatively minor changes to the current system, which means that the cost is projected to be relatively unchanged. (On the assumption of increased Pillar 2 coverage, we have come up with a slightly higher projected cost). The only difference of any substance is in relation to the change of rules for tax relief on contributions. These will have the effect of spreading the relief more evenly, but it is questionable as to whether the extra relief for lower earners will result in increased coverage.

In summary:

Pros	Cons
Relatively minor change to current system	Relatively minor change to current system
Will address unevenness of tax reliefs	Impact on coverage levels is questionable

10 Assessment of Alternative System 2

10.1 Introduction

As outlined in section 4.3, this system involves the introduction of a mandatory defined contribution scheme which would be operated by private-sector pension providers (with further contributions payable to voluntary arrangements if desired). Tax relief is assumed to be at the rate of 42% for all contributors, with a cap on relief for higher earning contributors.

10.2 Methodology and assumptions

The methodology and assumptions used to assess this system are as set out in Chapters 5, 6 and 7. They are the same as those used in assessing the current system, with the following exceptions:

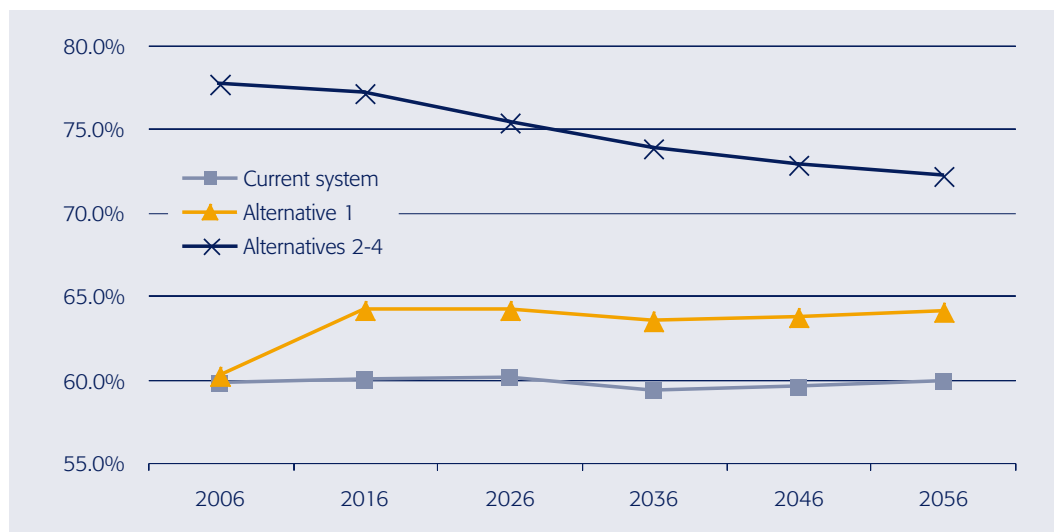
- Coverage rates: We assumed that there would be no future new entrants to existing voluntary schemes, except in the highest income band (as everyone, other than the lowest earners, will be joining the new mandatory arrangements).
- Employee contributions: We assumed that voluntary contributions would reduce by the amount of the mandatory contributions.
- Employer contributions: We assumed that employer contributions would continue at a lower rate, such that the total employer contribution (to existing arrangements and new mandatory arrangements) would be unchanged. Note that for personal pension arrangements, the mandatory 5% contribution which would be payable by employers in the case of those in occupational schemes is assumed to be paid by the individual (i.e. the self-employed pay mandatory contributions of 10% in total).
- Tax relief on contributions: As for Alternative System 1, we used a 42% tax rate (plus an allowance for PRSI as before), rather than the marginal tax rate. Mandatory contributions qualified for tax relief, in accordance with the Pensions Board's specification of this system.
- Expenses: We assumed a reduction in yield of 1.0% (rather than 1.5% p.a.) on mandatory assets. It seems reasonable to assume lower costs for the mandatory component, as at least that part of the costs which relates to the sales process will no longer apply. Furthermore, improved economies of scale should allow pension providers to price their products more keenly.

Finally, we assumed that all public servants would be subject to the mandatory arrangements. This is a difficult issue. On the one hand, our assumption could be attacked on the grounds that public servants are already well provided for from a pensions perspective and hence do not need any additional provision. On the other hand, it is difficult to see how introducing a mandatory scheme (with mandatory employee contributions) which did not also apply public servants would be acceptable to the private sector. Following discussions with the executive of the Pensions Board, we were instructed to include public servants within the mandatory net on the basis that this approach would be more useful in comparing systems²⁸.

These assumptions resulted in the following projected coverage levels under Alternative System 2. (It should be noted that the projected coverage levels for Alternative Systems 3 and 4 are, by definition, identical to those of System 2, although the level of pensions payable under those systems – i.e. their adequacy – would be expected to differ.) The corresponding figures for the current system and for Alternative System 1 are also shown in Figure 10.1 for comparison purposes.

²⁸ The additional net cost to the Exchequer which results from the assumption that the State would pay mandatory employer contributions in respect of public servants can be derived simply by taking the difference between the relevant figures for the cost of 'Public service pensions' in Table 7.13 and those in Table 10.1. In summary, the impact is 0.2% of GNP per annum.

Figure 10.1: Projected pension coverage rates (% of labour force aged 30-64) for various systems



Notes:

1. Figures include all Pillar 2 provision (public and private sector; voluntary and mandatory), but do not include Pillar 1 provision.
2. Figures are on the basis of the central demographic assumptions.
3. For Alternative System 1, projected coverage levels are a function of agreed assumptions (increased coverage at lower income levels). See 9.2 for details.
4. For Alternative Systems 2-4, projected coverage levels are affected by the agreed assumptions regarding the impact of mandatory pensions on voluntary coverage. See 10.2 for details.

10.3 Direct and indirect Exchequer costs

On this basis, the projected net cost to the Exchequer is as set out in Table 10.1.

Table 10.1: System 2: Projected costs and revenues to 2056 as a % of GNP; central scenario

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	3.0%	3.7%	4.9%	6.5%	8.7%	10.1%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions	1.2%	1.8%	2.4%	2.8%	3.0%	3.1%
NPRF	1.0%	1.0%	0.7%	(0.9%)	(2.7%)	(3.5%)
Tax relief on contributions	1.3%	1.4%	1.4%	1.4%	1.2%	1.2%
Tax relief on investment income	0.4%	0.6%	0.8%	0.9%	1.0%	0.9%
Tax revenue from pensions	(0.2%)	(0.2%)	(0.3%)	(0.5%)	(0.8%)	(0.8%)
Net cost to the Exchequer	3.0%	4.6%	6.2%	6.5%	6.7%	7.3%
Increase vs. current system	0.5%	0.6%	0.6%	0.6%	0.4%	0.3%

As can be seen from the Table, the net cost to the Exchequer is projected to be somewhat higher under this system than for the current system. This reflects the cost of mandatory employer contributions in respect of public servants as well as the increased cost of tax reliefs on mandatory contributions and on the investment income and gains earned on the accumulated mandatory assets, partially offset by the increased tax revenue from the resulting higher pensions down the line. Over time, the additional cost reduces as the membership of voluntary schemes declines.

Overall, one could summarise this by saying that there is projected to be a net incremental cost to the Exchequer of approximately 0.6% p.a. of GNP, falling over time, of providing everyone with a mandatory pension based on a privately-run defined contribution system with total contributions of 10% of earnings. Of course, whilst the net Exchequer cost is relatively modest, the mandatory contributions represent a considerable imposition on employers and employees. The economic, competitiveness and employment impacts of those additional contributions are examined in section 10.5 below.

The results on the basis of the alternative assumptions for mortality and migration are set out in Appendix B.

10.4 Sustainability

The comments for this system largely mirror those for the current system. As can be seen, this system suffers from the same fundamental problem (i.e. sharply increasing cost), but is projected to be somewhat more expensive than the current system (reflecting the cost of mandatory employer contributions in respect of public servants and the cost of tax reliefs on mandatory contributions).

10.5 Economic/competitiveness/employment impacts

Section 5.2.2 provides a high-level summary of the methodology we used to analyse the economic impact of introducing alternative pension systems.

The first step was to calculate the additional contributions which would be payable under System 2, compared with the current system.

Table 10.2: System 2: Additional contributions payable (as % of labour force earnings)

	2006	2016	2026	2036	2046	2056
Current system	7.0%	7.2%	7.4%	7.1%	6.8%	6.7%
Alternative System 2	7.6%	7.8%	8.1%	7.8%	6.9%	6.9%
Increase over current system	0.6%	0.6%	0.7%	0.7%	0.1%	0.2%

Notes:

1. Contributions include private sector employer and employee contributions to voluntary and mandatory Pillar 2 schemes and public sector mandatory employee contributions.
2. The figures are on the basis of the central demographic assumptions.

When expressed as a percentage of GNP, the additional contributions in 2006 under System 2 amount to 0.26% of GNP.

We took the figure of 0.26% of GNP and asked what the impact would be currently of imposing taxes, split between employers and employees, of that magnitude. The results are shown in Table 10.3.

It can be seen that GNP is projected to be 0.07% lower in the first year than it otherwise would be, and in the fifth year after the taxes are imposed, GNP is 0.06% lower. Employment is also lower and the unemployment rate is higher. Based on an employment level of around 2 million people, the projected fall in employment of 0.11% translates into approximately 2,000 jobs.

The reduction in economic activity leads to a reduction in inflationary pressures and so the consumer price level (as opposed to rate of change, or inflation) is projected to be 0.17% lower in the first year.

Wages are projected to rise. Although a fall in labour demand would tend to reduce wages, the fall in labour supply has the opposite effect. The simulation suggests that the supply effect dominates. However, the wage increase is not enough to offset the implicit tax increase and so real disposable income falls.

Table 10.3: Effect of introducing System 2, % change compared to base

	Year 1	Year 5
GNP	-0.07	-0.06
Employment	-0.11	-0.12
Unemployment Rate*	+0.09	+0.06
Consumer Prices	-0.17	-0.10
Wages	+0.13	+0.15
Real Personal Disposable Income	-0.16	-0.17

* percentage points change

10.6 Inter-generational equity

The issues under this heading are as set out for the current system (see section 8.2).

10.7 Intra-generational (re)distributive effects

The mandatory defined contribution element of this system has no redistributive effect. In addition, as those earning less than the PRSI threshold are not covered, it does nothing to improve the position of the lowest earners.

Whilst not related to a discussion of the (re)distributive effects of the system, it is important to appreciate the projected size of the mandatory pensions which this system will deliver. Table 10.4 illustrates the projected replacement rates from the mandatory pension component for a new entrant aged 25 (assuming retirement at 65 on a full contribution history and assuming that the pension increases with price inflation in payment).

Table 10.4: System 2: Projected replacement rates from mandatory component

	Earnings level (as % of gross average industrial earnings)			
	0.5 x GAIE	1.0 x GAIE	2.0 x GAIE	3.0 x GAIE
Male	0.0%	11.6%	17.0%	11.4%
Female	0.0%	10.3%	15.1%	10.1%

Thus, for a male entering work at 25 and earning gross average industrial earnings, the mandatory component of System 2 is projected to replace approximately 12% of gross earnings. When combined with the Pillar 1 pension (34% of GAIE), the total replacement ratio rises to approximately 46% of earnings. The corresponding figures for a female are approximately 10% and 44% respectively. In both cases, therefore, the projected replacement ratios are less than the NPPI replacement income target of 50%.

Two points need to be borne in mind, however, when evaluating these projected replacement ratios (particularly when comparing them with the corresponding figures for Alternative System 4). Firstly, the rates quoted in Table 10.4 are “average” projected rates: that is to say, they are the replacement rates which would be obtained if each year’s actual investment returns were exactly in line with our assumptions. Of course, given the defined contribution nature of this system, some individuals can be expected to do better than this and others can be expected to do worse, depending on the actual rates of return achieved in practice. Secondly, the replacement rates quoted above are on the basis of a pension which will increase in payment in line with price inflation (as opposed to a pension linked to earnings inflation for Alternative System 4). We return to this point in section 11.7 below when examining the projected replacement rates for Alternative System 3.

Finally, it is important to appreciate that these are, broadly speaking, the maximum replacement rates which we can expect from the mandatory system i.e. the replacement rates will be highest for new entrants with full contribution histories (all other things being equal). For those already in the workforce, and particularly those close to retirement, the mandatory component of this system will deliver lower benefits.

10.8 Administration costs and relative efficiency

As noted in 10.2 above, when assessing this system we assumed lower Pillar 2 costs, on the basis of a simplified sales process and scope for greater economies of scale.

Given the mandatory nature of System 2, the market for pensions in Ireland would expand to approximately 1.4 million people (i.e. those in the labour force earning more than the PRSI threshold) which should allow the largest pension providers to price their products more keenly than at present. One could then allow market forces to dictate the level of charges for mandatory pensions or one could decide to impose a price cap (as is currently the case with Standard PRSAs). In this regard, it is instructive to note that UK stakeholder pensions, which are a simple pension product somewhat similar to our PRSAs, are limited to charging 1% p.a. on the fund value.

If a price cap is to be introduced, one of the key issues which will need to be addressed in assessing the appropriate level of the cap is the question of the cost of providing financial advice. This is an issue which has exercised the pension providers and the financial regulator in the UK in the context of stakeholder pensions and we suggest that lessons can be learned from the UK experience.

An extensive international comparison of charges for funded pension arrangements, along with a discussion of the issues involved, can be found in a discussion paper published by Edward Whitehouse under the auspices of the World Bank's Social Protection Unit²⁹.

10.9 The relative merits of funding versus pay as you go

The issues under this heading are as set out for the current system (see sections 5.2.6 and 8.5).

10.10 Effect on the national savings rate

When it comes to assessing the effect on the national savings rate, the potential impact on savings is similar for Systems 2 to 4 (with one exception that we discuss below). In each case a form of compulsory saving is introduced and so it might be thought that savings would increase. However, this may not be the case if people respond to compulsory savings by reducing other forms of savings. At an extreme, it is even possible that people could borrow against future pension guarantees, whereby no additional savings arise.

An interesting study of this "displacement" issue has been undertaken in Australia and its results are illuminating on this point³⁰. By tracking trends in savings, the authors were able to estimate how total savings responded to Australia's introduction of compulsory pension savings. Their results suggest that for every dollar of compulsory saving, total savings rose by 62 cent. Hence, although other forms of saving did fall in response to compulsory saving, the offset was far from total. It is not possible to say if this result would generalize to Ireland but the high proportion of additional saving points to a possible increase here in response to compulsory saving.

29 Whitehouse E. (2000), *Administrative Charges for Funded Pensions: An International Comparison and Assessment*, Social Protection Discussion Paper No. 0016.

30 Connolly E. and Kohler M. (2004), *The Impact of Superannuation on Household Saving*, Reserve Bank of Australia, Economic Research Department Discussion Paper No. 2004-1.

We noted above that a possible difference could arise between Systems 2, 3 and 4 and we will discuss this point here. If the compulsory saving is paid to the Government and not private pension managers, the option might be available to the Government to use the funds to fund current expenditure. This could give rise to a situation in which a change in household saving is offset by a change in government saving in the opposite direction. This points to a need to ensure that any funds paid to the Government under a compulsory scheme should be diverted into an NPRF-like fund.

10.11 Summary

Under this system, the net cost to the Exchequer is projected to be somewhat higher than for the current system, reflecting the cost of mandatory contributions for public servants and the increased cost of tax reliefs on mandatory contributions. Imposing mandatory contributions on employers and employees is also likely to have some economic and employment impacts.

The obvious advantage with any mandatory Pillar 2 system is that it ensures that everyone above the minimum qualifying income threshold has some form of supplementary pension in addition to the basic flat-rate Pillar 1 benefit. The challenge is to ensure that the system is properly calibrated to ensure that the target benefits are appropriate without the system becoming overly burdensome. For a defined contribution system this translates into setting contribution rates which are projected to deliver the desired level of benefit (see below).

A criticism which may be levelled at any mandatory system is that it forces people to save who would prefer to invest their money elsewhere (or to spend it). In other words, it removes freedom of choice. Mandatory pension contributions are likely to be viewed by many as an additional tax on their income. In addition, many younger employees are likely to want to save for a deposit for a house and the imposition of a mandatory pension savings system could be quite unpopular amongst this group. More generally there appears to be a widely-held distrust of pension providers and scepticism about the benefits of saving for retirement through conventional pension plans (as opposed to through investment in property, for example).

Another criticism of mandatory systems (in general) is that, in many cases, once introduced the mandatory minimum contribution becomes the total contribution. In other words people do not make any additional provision over and above the minimum required. This raises questions of adequacy. It is generally recognised that the majority of existing defined contribution occupational schemes typically involve a contribution of approximately 10% of earnings³¹ (often split 5% from the employer and 5% from the employee) and that these contribution levels are insufficient to provide adequate pension income for many employees³².

For a significant proportion of the private sector, therefore, the mandatory system is likely merely to replace the current voluntary arrangements (which are widely viewed as inadequate). Indeed some existing defined contribution members may end up worse off if their current voluntary arrangements (which typically involve contributions of approximately 10% of all earnings) are discontinued and are replaced with a mandatory system which requires contributions of 10% on earnings above a threshold and subject to a cap.

There is also the question of the suitability of this system for workers in the public sector. As noted in section 10.2, there are problems with including public sector workers within the scope of any mandatory supplementary system (i.e. over provision) as well as with excluding them (i.e. equity between public sector and private sector workers). Indeed, more generally, there are likely to be significant practical issues of detail which will need to be worked out if a mandatory component is to be introduced and integrated with the existing voluntary Pillar 2 arrangements (both public and private sector).

³¹ See, for example, Mercer (2005), *Defined Contribution Benefits Survey for Ireland*

³² See Society of Actuaries in Ireland (2003), *Position paper on Defined Contribution Plans & PRSAs* and Irish Association of Pension Funds (2003), *Defined Contribution Adequacy*

There are further difficulties with a mandatory defined contribution system. As with any defined contribution system, there will be a risk that contributors may suffer losses as a result of poor investment returns. The question of how acceptable this would be needs to be considered, although it is arguable that a privately-run (as opposed to a State-run) system might make this easier to manage from a political perspective. In this scenario, however, private-sector pension providers would have to make very clear to contributors the potential risks and rewards of the various investment options available. A private-sector system also brings the additional risk that a financial institution may itself run into financial difficulties at some point in the future, with potentially negative consequences for those whose pensions are invested with it.

There are other factors which would need to be considered in comparing this system with System 3 (a State-run defined contribution system). These are set out in the assessment of System 3 below.

In summary:

Pros	Cons
Universal coverage	Arguments against compulsion
Relatively limited economic impact	Arguments re adequacy
Relatively limited additional cost to Exchequer	Risk of loss (as with any DC scheme)
	Institutional risk
	Distrust of current pension providers?
	Higher charges than for a State-run system?

11 Assessment of Alternative System 3

11.1 Introduction

As outlined in section 4.4, this system involves the introduction of a mandatory defined contribution scheme which would be operated by the State (with further contributions payable to voluntary arrangements if desired). Tax relief is assumed to be at the rate of 42% for all contributors, with a cap on relief for higher earning contributors.

11.2 Methodology and assumptions

As it is a variant of Alternative System 2, the methodology and assumptions used to assess this system were very similar to those set out in section 10.2 in respect of that system. (We assume, as for System 2, that the mandatory component of this system would be run on a funded basis.)

The only exception was that the allowance for expenses in the mandatory component was modelled using a reduction in yield of 0.5% (rather than 1.0% in Alternative System 2). It seems reasonable to assume lower costs for the mandatory component than under System 2 as the costs should be lower again, reflecting the savings which could be obtained from having a simple single-provider system, general economies of scale, the State's purchasing power and the absence of a profit margin. It should be noted that this assumption does not constitute a judgement on our part about the relative efficiencies of the public and private sectors. We are simply commenting that a system with the characteristics of System 3 should be simpler and cheaper to run than a system with the characteristics of System 2. In any event, this is a relatively unimportant assumption when looking at the net cost to the Exchequer.

11.3 Direct and indirect Exchequer costs

On this basis, the projected net cost to the Exchequer is as set out in Table 11.1.

Table 11.1: System 3: Projected costs and revenues to 2056 as a % of GNP; central scenario

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions*	3.0%	3.7%	4.9%	6.5%	8.7%	10.1%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions	1.2%	1.8%	2.4%	2.8%	3.0%	3.1%
NPRF	1.0%	1.0%	0.7%	(0.9%)	(2.7%)	(3.5%)
Tax relief on contributions	1.3%	1.4%	1.4%	1.4%	1.2%	1.2%
Tax relief on investment income	0.4%	0.6%	0.8%	1.0%	1.1%	1.1%
Tax revenue from pensions	(0.2%)	(0.2%)	(0.3%)	(0.5%)	(0.8%)	(0.9%)
Net cost to the Exchequer	3.0%	4.6%	6.2%	6.6%	6.8%	7.4%
Increase vs. current system	0.5%	0.6%	0.6%	0.7%	0.5%	0.4%

* A note on presentation: In EU terminology, Pillar 1 includes all State provision (i.e. the proposed mandatory State-run DC system should properly be categorised as Pillar 1). For simplicity and comparability, however, we have not included the proposed mandatory system under Pillar 1. In our terminology, therefore, Pillar 1 refers solely to the basic State benefit.

Given that this system is closely related to Alternative System 2, it is not surprising that the results are quite similar. As with Alternative 2, the net cost to the Exchequer is projected to be somewhat higher under this system than for the current system, reflecting the increased cost of the enhanced Pillar 2.

The net cost for System 3 is projected to be marginally higher than for System 2. This reflects the fact that, because the amount "lost" due to expenses is assumed to be lower in this system, the accumulated assets grow at a faster rate and hence give rise to a higher cost of tax relief on the investment income & gains. These additional assets will ultimately translate into higher pensions, so the additional cost should net out to close to nil over the very long-term as tax revenues are received on those higher pensions.

It should be noted that we have not made any allowance in the figures in Table 11.1 for the additional administration costs which would be incurred by the State in administering the mandatory DC component of this system. However, these would not significantly add to the net Exchequer cost as shown in the table above. (To put this in context, annual running costs of €140 million would equate to 0.1% of GNP).

When looking at the costs to the Exchequer of System 3 (and to a lesser extent System 2), some account should be taken of the political pressure that may exist in future years to make payments that are more generous than those warranted by the value of retirees' accumulated funds. The putting in place of compulsory DC-type arrangements may create a feeling among individuals that pension incomes of a certain level are now guaranteed. To the extent that benefits may fall short of expectations, there will be pressure for Government to add to payments. This will come about in a situation in which retirees form a much higher proportion of the electorate and so the extent of the pressure is likely to be very considerable.

The results on the basis of the alternative assumptions for mortality and migration are set out in Appendix B.

11.4 Sustainability

The comments for this system largely mirror those for the current system. As can be seen, this system suffers from the same fundamental problem (i.e. sharply increasing cost), but is projected to be somewhat more expensive than the current system (reflecting the cost of mandatory employer contributions in respect of public servants and the cost of tax reliefs on mandatory contributions).

11.5 Economic/competitiveness/employment impacts

The general economic issues under this heading are substantially as outlined for System 2 (see section 10.5). In addition, however, the specific impact on the financial services sector would need to be borne in mind – a move to a mandatory State-run pension system would have significant implications for private sector pension providers.³³

11.6 Inter-generational equity

The issues under this heading are as set out for the current system (see section 8.2).

11.7 Intra-generational (re)distributive effects

As with System 2, the mandatory defined contribution element of this system has no redistributive effect. In addition, as those earning less than the PRSI threshold are not covered, it does nothing to improve the position of the lowest earners.

In addition our comments regarding replacement rates and adequacy are essentially as for System 2. Our assumption of lower expenses leads to slightly higher pensions (see Table 11.2 versus Table 10.4) but the increase in replacement ratio compared to System 2 is relatively modest.

³³ By way of background information, there are some 6,000 people employed by Irish life assurance companies (although some of these are employed by IFSC companies which do not service the Irish market). Furthermore, only a proportion of the Irish companies' employees work in the pensions area. In addition, there are some 2,400 entities (excluding solicitors, accountants etc.) which are registered as financial services intermediaries, some of which will employ staff who are engaged in transacting pension business. Very approximately, therefore, we may estimate that there are perhaps 10,000 to 15,000 individuals directly involved in the private pensions area. It needs to be borne in mind, however, that intermediaries tend to focus on the higher income groups (as well as typically providing other financial services) and hence may still have a market for their services, even in a mandatory State pensions environment.

Table 11.2: System 3: Projected replacement rates from mandatory component (price inflation)

	Earnings level (as % of gross average industrial earnings)			
	0.5 x GAIE	1.0 x GAIE	2.0 x GAIE	3.0 x GAIE
Male	0.0%	12.8%	18.8%	12.5%
Female	0.0%	11.3%	16.6%	11.1%

Thus, for a male entering work at 25 and earning gross average industrial earnings, the mandatory component of System 3 is projected to replace approximately 13% of gross earnings. When combined with the Pillar 1 pension (34% of GAIE), the total replacement ratio rises to approximately 47% of earnings. The corresponding figures for a female are approximately 11% and 45% respectively. As for System 2, it needs to be borne in mind that these are “average” projected replacement rates, based on an assumption of stable and positive investment returns; the reality is that individuals will do better or worse than the average depending on the actual investment returns earned on their savings.

Note that the replacement rates quoted above have been derived on the basis of a pension which will increase in payment in line with price inflation. This makes the figures comparable with those quoted for System 2 (see section 10.7). However, in order to make valid comparisons with System 4, it is necessary to recalculate the replacement rates on the basis of an earnings-linked pension. The resulting replacement rates are as set out in Table 11.3.

Table 11.3: System 3: Projected replacement rates from mandatory component (earnings inflation)

	Earnings level (as % of gross average industrial earnings)			
	0.5 x GAIE	1.0 x GAIE	2.0 x GAIE	3.0 x GAIE
Male	0.0%	10.0%	14.7%	9.8%
Female	0.0%	8.6%	12.6%	8.4%

Finally, as with System 2, the mandatory component of this system will deliver lower replacement ratios for those already in the workforce, and particularly those close to retirement.

11.8 Administration costs and relative efficiency

As noted in 11.2 above, when assessing this system we assumed that Pillar 2 costs would be lower than under System 2. Our rationale for this assumption was that lower costs ought to be attainable given the potential savings from having a simple single-provider system, general economies of scale, the State’s purchasing power and the absence of a profit margin.

It should be noted that this assumption does not constitute a judgement on our part about the relative efficiencies of the public and private sectors. We are simply commenting that a system with the characteristics of System 3 should be simpler and cheaper to run than a system with the characteristics of System 2.

In this regard, it is important to bear in mind that there are many possible approaches to operating System 3, ranging from full State control (whereby the State collects the contributions, pays benefits, keeps the necessary records and also manages the investments) to a fully outsourced model where all of these functions are carried out by private-sector contractors.

The operation of the National Pensions Reserve Fund is an example of a partially-outsourced model – the management of the fund’s investments is handled by external investment managers, subject to control and review by the commission charged with oversight of the fund. Similar models are possible with a State-run defined contribution scheme, although in this case there would be more functions to consider

(e.g. member record-keeping, benefit payments, handling member queries etc.). There is also the question of who would provide investment advice to members and/or conduct regular reviews of the progress of their retirement funds.

11.9 The relative merits of funding versus pay as you go

The issues under this heading are as set out for the current system (see sections 5.2.6 and 8.5). (We assume that the mandatory component of this system would be run on a funded basis.)

11.10 Effect on the national savings rate

The issues under this heading are as set out in section 10.10 above.

11.11 Summary

System 3 is a variation on System 2, but with the mandatory scheme administered by the State rather than by private institutions. As a result, the comments outlined in 10.11 for System 2 also apply to this system.

However, the whole issue of guarantees is probably more important in the case of a State-run system than it is in the case of a privately-run system. Providing guarantees will have an additional cost, but the amount is difficult to quantify without a detailed specification of the proposed system design. If the government did decide that guarantees would be required in order to make the scheme acceptable, this raises the question as to why one would bother with a defined contribution arrangement at all – why not introduce some form of defined benefit arrangement instead (e.g. an earnings-related system along the lines of System 4)?

One advantage of System 3 over System 4, however, is that it would be easier to adjust the system to allow for increasing longevity. The annuity rate at retirement age could be adjusted from time to time in the light of improvements in life expectancy. It would also allow flexibility with regard to the retirement age – the annuity rate would reflect the age at which the pension is taken.

Other factors which would need to be borne in mind when evaluating the pros and cons of a State-run mandatory defined contribution system as opposed to a privately-run one include:

- Freedom of choice: One provider (the State) as opposed to many (private institutions). However, even with a State-run system it would be possible to offer contributors a range of investment options and investment managers (e.g. investment with private sector fund managers via the NTMA).
- Scepticism/distrust: It appears that many people are sceptical or distrustful of private-sector pension providers. On the other hand, people may be more inclined to view contributions to a State-run system as a tax then might be the case with a privately-run system.
- Charges: It is reasonable to suppose that a single-provider system could levy lower charges than a multi-provider system.
- The impact on employment, profitability etc. within the financial services industry.

In summary:

Pros	Cons
Generally as for System 2	Generally as for System 2
Lower charges than System 2?	Requirement for a State guarantee?
	Impact on employment etc. in financial institutions

12 Assessment of Alternative System 4

12.1 Introduction

As outlined in section 4.5, this system involves the introduction of a mandatory supplementary State earnings-related system, providing a benefit of 1% of revalued annual pensionable earnings for each year of contribution. (Pensionable earnings would be defined as earnings above the employee PRSI minimum up to a maximum of twice average industrial earnings.)

The contribution rate for this System would be set at a rate which is calculated to be cost-neutral in the long-term. As for Systems 2 and 3, further contributions may be paid to voluntary arrangements if desired. Tax relief is assumed to be at the rate of 42% for all contributors, with a cap on relief for higher earning contributors.

12.2 Methodology and assumptions

As Alternative System 4 is another State-run mandatory system (albeit a defined benefit rather than defined contribution one), the methodology and assumptions used to assess this system were very similar to those set out in section 11.2 in respect of System 3.

We calculated that a contribution rate of 26.5% of pensionable earnings would be required to fund the mandatory earnings-related system. (This is the new entrant rate, although it is relatively insensitive to the age assumption.) In arriving at this rate we assumed an investment return equal to GNP growth, less expenses³⁴. We also assumed that the pension would increase in payment in line with earnings inflation.

As for systems 2 and 3, mandatory contributions attract tax relief (at 42% for all) and we also assumed that all public servants would be subject to the mandatory arrangements (see our comments in 10.2).

12.3 Direct and indirect Exchequer costs

On this basis, the projected net cost to the Exchequer is as set out in Table 12.1. The figures have been calculated on the basis that the mandatory component would be operated on a funded basis (see 12.9 below for the figures on a PAYG basis).

Table 12.1: System 4: Projected costs and revenues to 2056 as a % of GNP; central scenario; Funded

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions*	3.0%	3.7%	4.9%	6.5%	8.7%	10.1%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions	1.7%	2.2%	2.8%	3.2%	3.4%	3.5%
NPRF	1.0%	1.0%	0.7%	(0.9%)	(2.7%)	(3.5%)
Tax relief on contributions	1.9%	2.0%	2.0%	2.0%	2.0%	2.0%
Tax relief on investment income	0.4%	0.3%	0.2%	0.2%	0.1%	0.1%
Tax revenue from pensions	(0.2%)	(0.2%)	(0.3%)	(0.5%)	(0.9%)	(1.2%)
Net cost to the Exchequer	4.1%	5.3%	6.6%	6.8%	6.9%	7.3%
Increase vs. current system	1.6%	1.3%	1.0%	0.9%	0.6%	0.3%

* A note on presentation: In EU terminology, Pillar 1 includes all State provision (i.e. the proposed mandatory State earnings-related system should properly be categorised as Pillar 1). For simplicity and comparability, however, we have not included the proposed mandatory system under Pillar 1. In our terminology, therefore, Pillar 1 refers solely to the basic State benefit.

³⁴ If, alternatively, we assumed that contributions would be invested in a fund earning a real return of 3.5% p.a., the required contribution rate would be approximately 20%. It is open to question, however, whether it would be feasible to obtain returns substantially in excess of GNP growth given the projected size of the resulting fund (c. 200% of GNP by 2056).

Under System 4, therefore, there is an immediate increase in the net Exchequer cost reflecting the cost of mandatory employer contributions for public servants³⁵ and the increased level of tax relief on the increased contributions. Over time, the gap narrows due to the decline in the cost of tax relief on investment income & gains on Pillar 2 assets (as those assets run down) and the impact of increased tax revenues from pensions in payment, which begins to be a factor from about 2030 onwards.

As with System 3, we have not incorporated any allowance in our figures above for the additional administration costs which would be incurred by the State in administering the mandatory component of this system. However, once again, these would not significantly add to the net Exchequer cost as shown in the table above.

The results on the basis of the alternative assumptions for mortality and migration are set out in Appendix B.

12.4 Sustainability

In terms of sustainability, the system should be as sustainable as the current system if the mandatory component is run on a funded basis with the contribution rate as derived above (as the contribution rate has been derived on the basis of ensuring that the mandatory component is cost-neutral in the long run). The major difficulty, however, is the extremely high level of contribution rate required to fund the system. Our comments on the merits of funding versus PAYG are also relevant to this discussion (see 12.9 below).

12.5 Economic/competitiveness/employment impacts

Section 5.2.2 provides a high-level summary of the methodology we used to analyse the economic impact of introducing alternative pension systems.

The first step was to calculate the additional contributions which would be payable under System 4, compared with the current system.

Table 12.2: System 4: Additional contributions payable (as % of labour force earnings)

	2006	2016	2026	2036	2046	2056
Current system	7.0%	7.2%	7.4%	7.1%	6.8%	6.7%
Alternative System 4	12.0%	12.4%	12.5%	12.6%	12.3%	12.2%
Increase over current system	5.0%	5.2%	5.1%	5.5%	5.5%	5.5%

Notes:

1. Contributions include private sector employer and employee contributions to voluntary and mandatory Pillar 2 schemes and public sector mandatory employee contributions.
2. The figures are on the basis of the central demographic assumptions.

The value of the aggregate contributions under this system that are over and above the existing level of contributions is equivalent to 2.2% of GNP in 2006. In Table 12.3 we show the results of our simulation of the effect of introducing this system.

The introduction of System 4 would see GNP being 0.6% lower in the first year and 0.5% lower in year 5. In terms of employment, the fall would be 1.0% – or around 20,000 jobs, based on employment of 2 million.

³⁵ The additional net cost to the Exchequer which results from the assumption that the State would pay mandatory employer contributions in respect of public servants can be derived simply by taking the difference between the relevant figures for the cost of 'Public service pensions' in Table 7.13 and those in Table 12.1. In summary, the impact is roughly 0.6% of GNP per annum.

Table 12.3: Effect of introducing System 4, % change compared to base

	Year 1	Year 5
GNP	-0.55	-0.51
Employment	-0.90	-1.05
Unemployment Rate*	+0.74	+0.47
Consumer Prices	-1.42	-0.84
Wages	+1.07	+1.23
Real Personal Disposable Income	-1.31	-1.45

* percentage points change

Finally in this section, it is worth bearing in mind the potential impact on the financial services sector of a move to a mandatory State-run pension. See 11.5 for more detailed comments on this issue.

12.6 Inter-generational equity

Assuming that the new mandatory component is operated on a funded basis, the issues under this heading are as set out for the current system (see section 8.2). If the proposed mandatory component were to be operated on a pay-as-you-go basis, the discussion would then revolve around the pros and cons of funding as set out in section 12.9.

12.7 Intra-generational (re)distributive effects

As with Systems 2 and 3, the mandatory element of this system has no redistributive effect. In addition, as those earning less than the PRSI threshold are not covered, it does nothing to improve the position of the lowest earners.

Whilst not related to a discussion of the (re)distributive effects of the system, it is important to appreciate the projected size of the mandatory pensions which this system will deliver. Table 12.4 illustrates the projected replacement rates from the mandatory pension component for a new entrant aged 25 (assuming retirement at 65 and a full contribution history).

Table 12.4: System 4: Projected replacement rates from mandatory component

	Earnings level (as % of gross average industrial earnings)			
	0.5 x GAIE	1.0 x GAIE	2.0 x GAIE	3.0 x GAIE
Male	0.0%	20.6%	30.3%	20.2%
Female	0.0%	20.6%	30.3%	20.2%

Thus, for someone entering work at 25 and earning gross average industrial earnings, the mandatory component of System 4 is projected to replace approximately 21% of gross earnings. When combined with the Pillar 1 pension (34% of GAIE), the total replacement ratio rises to approximately 55% of earnings. The pension amount is independent of sex (which raises gender equity issues).

This system delivers significantly better replacement ratios than Systems 2 and 3, therefore (see 10.7 and 11.7 for comparisons). In fact, the difference between System 4 and System 2 is greater than a simple comparison of the respective replacement ratios would suggest: the System 4 pension has been calculated on the basis of earnings inflation in payment, whereas the System 2 pensions have been calculated on the basis of price inflation.

Finally, it is important to appreciate that the replacement rates quoted above are, broadly speaking, the maximum replacement rates which we can expect from the mandatory system i.e. the replacement rates will be highest for new entrants with full contribution histories (all other things being equal). For those already in the workforce, and particularly those close to retirement, the mandatory component of this system will deliver lower benefits.

12.8 Administration costs and relative efficiency

The arguments under this heading are quite similar to those for System 3 (see section 11.8), although in the case of this system there is no requirement to provide members with investment options. (Indeed, if the system is run on a pay-as-you-go basis there is no need to invest at all). It is open to debate as to whether a defined contribution or an earnings-related system is more complex from an administrative and record-keeping perspective.

12.9 The relative merits of funding versus pay as you go

Under this system, a decision would be required as to whether or not to fund the new mandatory earnings-related system. The issues under this heading are as set out for the current system (see sections 5.2.6 and 8.5), although the introduction of the additional mandatory component adds greatly to the size of the State pensions system. Running the mandatory component on a PAYG basis would simply create a bigger sustainability problem (but defer it to beyond 2056).

With this system, the high level of mandatory contributions would lead to a substantial (but illusory) improvement in the Exchequer finances in the short-term if looked at on a pay-as-you-go basis. As we move forward, however, the difference would gradually narrow and ultimately reverse.

The projected net Exchequer cost on a PAYG basis would be as follows:

Table 12.5: System 4: Projected costs and revenues to 2056 as a % of GNP; central scenario; PAYG

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	3.0%	3.7%	4.9%	6.5%	8.7%	10.1%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions	1.7%	2.2%	2.8%	3.2%	3.4%	3.5%
NPRF	1.0%	1.0%	0.7%	(0.9%)	(2.7%)	(3.5%)
Mandatory system net cashflow	(5.5%)	(5.6%)	(5.1%)	(4.0%)	(2.2%)	(0.8%)
Tax relief on contributions	1.9%	2.0%	2.0%	2.0%	2.0%	2.0%
Tax relief on investment income	0.4%	0.3%	0.2%	0.2%	0.1%	0.1%
Tax revenue from pensions	(0.2%)	(0.2%)	(0.3%)	(0.5%)	(0.9%)	(1.2%)
Net cost to the Exchequer	(1.4%)	(0.3%)	1.5%	2.8%	4.7%	6.5%
Increase vs. current system	(3.9%)	(4.3%)	(4.1%)	(3.1%)	(1.6%)	(0.5%)

12.10 Effect on the national savings rate

The issues under this heading are as set out in section 10.10 above.

12.11 Summary

The advantage of System 4 over System 3 is that it provides a relatively high mandatory defined benefit pension rather than a relatively low defined contribution one. The big drawback, however, is the cost of providing the higher pension.

In a sense this is quite analogous to the current debate about the relative merits of occupational defined contribution and defined benefit schemes³⁶. Defined contribution schemes are widely criticised as suffering from insufficient contributions (which are typically about the same level as those proposed in System 3 for the mandatory defined contribution system) whereas defined benefit schemes are seen as delivering better benefits but are far more expensive. In a sense, therefore, the choice between System 3 and System 4 mirrors this.

In practical terms, however, the level of contributions required to fund System 4 (26.5% on earnings above the employee PRSI threshold and up to twice the level of the average industrial wage) are almost certain to make it unworkable. It would, of course, be possible to design a cheaper earnings-related system, albeit one which delivers lower benefits.

Finally, the point made in section 10.11 about the practical difficulties of introducing and integrating any mandatory system when there are already voluntary Pillar 2 arrangements in place applies equally to this system.

In summary:

Pros	Cons
Provides an earnings-related pension	Extremely high contributions required
	Economic/competitiveness implications

³⁶ See, for example, ICTU (2005), *Irish Pensions: Problems & Solutions*

13 Assessment of Alternative System 5

13.1 Introduction

As outlined in section 4.6, this system entails an immediate increase in the level of the Pillar 1 flat-rate pension from 34% to 50% of the previous year's gross average industrial earnings, with the cost of the increase to be met by separately identifiable contributions to be paid by employers and employees. The contribution rate in respect of the additional pension would be set at a rate which is calculated to be cost-neutral in the long-term.

Other than this, the current system continues unchanged except for a change to the rules for tax relief on contributions to Pillar 2 arrangements: the contributions which would attract relief (both employer and employee) would be capped at the PRSA/RAC income limit.

13.2 Methodology and assumptions

The methodology and assumptions used to assess this system are as set out in Chapters 5, 6 and 7. They are the same as those used in assessing the current system, with the following exceptions:

- Coverage rates: We assumed that there would be no future new entrants to existing voluntary schemes, except in the highest income band (as everyone will be getting increased Pillar 1 benefits).
- Employee contributions: For defined contribution arrangements, we assumed that voluntary contributions would reduce by the amount of the mandatory contributions. For defined benefit schemes, contributions would reduce to reflect the impact of integration with a higher Pillar 1 benefit.
- Employer contributions: We assumed that employer contributions to defined contribution arrangements would continue at a lower rate, such that the total employer contribution (to existing arrangements and new mandatory arrangements) would be unchanged. For defined benefit schemes, employer contributions would reduce to reflect the impact of integration with a higher Pillar 1 benefit.
- Additional Pillar 1 contribution: The additional contribution which would be required to fund the increase in the Pillar 1 benefit, which we calculated as 9.2% (payable on all earnings)³⁷, was assumed to attract tax & PRSI relief at the contributor's marginal rate.
- Transition costs: In projecting the net Exchequer cost of this system, we assumed that the increase in Pillar 1 benefit would be immediately payable to all existing pensioners as well as to all future retirees. The additional contribution levied in respect of this additional benefit (which has been calculated on the basis of a new entrant funding rate), whilst sufficient to fund the increase in the long-term, would not, however, address the additional transitional costs which would result from granting the increase to those already retired (and to a lesser extent to those already in the workforce)³⁸. These additional costs have been reflected in the figures in 13.3 below.
- Additional Pillar 1 pensions: We assumed that the additional Pillar 1 pension (i.e. the extra amount resulting from the increase from 34% to 50%) would be taxed at 20%.

In contrast to Systems 2 to 4, our treatment of public service workers assumed that the additional Pillar pension would only be payable to those who were integrated with the social insurance system.

³⁷ This is the new entrant cost allowing for improving mortality. Note that, if the contribution were only to be payable on earnings above the employee PRSI threshold (currently approximately €15,000), the contribution rate would need to be higher than this.

³⁸ Those already in retirement, for example, will receive the full additional benefit without paying any additional contributions. Similarly, those already in the workforce will receive the full additional benefit despite paying less than a full career's worth of contributions.

13.3 Direct and indirect Exchequer costs

On this basis, the projected net cost to the Exchequer is as set out in Table 13.1. The figures have been calculated on the basis that the increase in the Pillar 1 benefit would be operated on a funded basis (see 13.9 below for the figures on a PAYG basis).

Table 13.1: System 5: Projected costs and revenues to 2056 as a % of GNP; central scenario; funded

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	4.4%	5.3%	6.6%	8.0%	9.8%	10.6%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions	1.1%	1.7%	2.4%	3.0%	3.2%	3.3%
NPRF	1.0%	1.0%	0.7%	(0.9%)	(2.7%)	(3.5%)
Tax relief on contributions	1.3%	1.4%	1.6%	1.6%	1.4%	1.4%
Tax relief on investment income	0.4%	0.4%	0.3%	0.3%	0.2%	0.2%
Tax revenue from pensions*	(0.5%)	(0.5%)	(0.7%)	(0.9%)	(1.2%)	(1.2%)
Net cost to the Exchequer	4.0%	5.6%	7.2%	7.4%	7.0%	7.1%
Increase vs. current system	1.5%	1.6%	1.6%	1.5%	0.7%	0.1%

* Note: In the case of System 5, this line includes tax revenue on the increase in the Pillar 1 pension.

Under this system the cost of Pillar 1 pensions initially increases pro-rata to the current system to reflect the increase in the level of benefit from 34% of GAIE to 50% of GAIE and the fact that no additional contributions have been received. Over time, the net cost of Pillar 1 pensions is projected revert towards the projected net cost under the current system (which is not surprising, given that the additional contributions required to fund the additional Pillar 1 benefits have been calculated so as to be cost neutral in the long-term). The additional cost of the increase in the Pillar 1 benefit is also partially offset by our assumption that the increase in this pension would be taxed at a rate of 20% on average.

Turning to some of the other components of the overall net Exchequer cost, the cost of public service pensions increases, reflecting the Exchequer cost of the employer share of the additional contributions (the additional contribution of 9.2% of earnings is assumed to be split 50:50 between employers and employees). The cost of tax relief on contributions is now also somewhat higher than for the current system, reflecting the additional 9.2% contributions. As with System 4, the cost of tax relief on Pillar 2 investment income is projected to decline as the Pillar 2 system shrinks. Tax revenue from pensions is impacted by two offsetting forces (the decline in Pillar 2 pensions and the increase in Pillar 1 pensions) with the net result that the tax revenue from pensions is projected to be somewhat higher than under the current system.

The results on the basis of the alternative assumptions for mortality and migration are set out in Appendix B.

13.4 Sustainability

Given that the only change in this system compared to the current system is that the Pillar 1 benefit has increased, and given that the contributions to finance that increase are payable at a rate which has been calculated to be cost neutral in the long-term, the sustainability issues for this system should, by definition, be identical to those of the current system (assuming the additional pension is run on a funded basis). Our comments on the merits of funding versus PAYG are also relevant to this discussion (see 13.9 below).

13.5 Economic/competitiveness/employment impacts

Section 5.2.2 provides a high-level summary of the methodology we used to analyse the economic impact of introducing alternative pension systems.

The first step was to calculate the additional contributions which would be payable under System 5, compared with the current system.

Table 13.2: System 5: Additional contributions payable (as % of labour force earnings)

	2006	2016	2026	2036	2046	2056
Current system	7.0%	7.2%	7.4%	7.1%	6.8%	6.7%
Alternative System 5	10.9%	10.8%	11.1%	11.0%	10.0%	10.0%
Increase over current system	3.9%	3.6%	3.7%	3.9%	3.2%	3.3%

Notes:

1. Contributions include private sector employer and employee contributions to Pillar 2 schemes. The additional private sector employer and employee contribution required to fund the proposed increase in the Pillar 1 pension is also included as well as the additional employee contribution to be paid by public service employees (but excluding the employer contributions to be paid by the government in respect of public servants).
2. The contributions payable under the existing PRSI system are not included.
3. Other than the additional employee contributions required to fund the proposed increase in the Pillar 1 pension, the public sector is not included.
4. The figures are on the basis of the central demographic assumptions.

The cost of System 5 arises from the additional contributions required to fund the increase in Pillar 1 pensions (1.8% of GNP in 2006). In Table 13.3, we show the results of our simulation of the impact of introducing this system. Just as the cost of System 5 lies between those of Systems 2/3 and System 4, so too do the measured impacts.

Table 13.3: Effect of introducing System 5, % change compared to base

	Year 1	Year 5
GNP	-0.44	-0.40
Employment	-0.71	-0.83
Unemployment Rate*	+0.58	+0.37
Consumer Prices	-1.12	-0.66
Wages	+0.84	+0.97
Real Personal Disposable Income	-1.03	-1.14

* percentage points change

13.6 Inter-generational equity

System 5 is the only one of the five alternative systems which will have a beneficial impact on existing pensioners – all of the other systems will only affect (to a greater or lesser extent) the pensions of future retirees. This brings a substantial and immediate increase in the cost of supporting the Pillar 1 system and thus exacerbates the pre-funding versus PAYG dilemma. It should be noted in this regard that the extra contributions which will be collected under this system do not address this extra “past service” cost – the additional contribution rate (9.2%) has been determined as the rate required to fund the extra benefits for a new entrant to the labour force.

Assuming that the new mandatory component is operated on a funded basis, the issues under this heading are as set out for the current system (see section 8.2). If the proposed mandatory component were to be operated on a pay-as-you-go basis, the discussion would then revolve around the pros and cons of funding as set out in section 13.9.

13.7 Intra-generational (re)distributive effects

As this system involves increasing the level of the State Pillar 1 benefit, it helps to address the criticisms³⁹ which are sometimes levelled at the current system i.e. that the Exchequer support for voluntary Pillar 2 provision is regressive (as it favours higher earners) and that it would be more equitable to direct State resources towards providing a higher level of Pillar 1 benefit.

13.8 Administration costs and relative efficiency

Under this system, the only change is an increase to the level of the Pillar 1 benefit. There are no particular administrative impacts, therefore. Accordingly, the level of administration costs and relative efficiency of this system should be as for the current system.

It is possible, however, that a side-effect of the increase in the Pillar 1 pension could be a substantial reduction in demand for Pillar 2 pensions (we have made some allowance for the potential impact in our assumptions in 13.2 above). In theory, this could have an impact on the price of those pensions, although in practice the price cap on standard PRSAs should serve to limit this. Furthermore, it is likely that those on high incomes (who make up a major proportion of the market for Pillar 2 pensions) will continue to want to make supplementary provision.

13.9 The relative merits of funding versus pay as you go

The issues under this heading are as set out for the current system (see sections 5.2.6 and 8.5), although the increase in the Pillar 1 pension adds greatly to the size of the State pensions system. Running the mandatory component (i.e. the increase in the Pillar 1 benefit) on a PAYG basis would simply create a bigger problem than at present and defer it to beyond 2056.

With this system, the high level of mandatory contributions would lead to a substantial (but illusory) improvement in the Exchequer finances in the short-term if looked at on a pay-as-you-go basis. As we move forward, however, the difference would gradually narrow and ultimately reverse.

The projected net Exchequer cost on a PAYG basis would be as follows:

³⁹ See, for example, Hughes G. and Watson D. (2005), *Pensioners' Incomes and Replacement Rates in 2000*

Table 13.4: System 5: Projected costs and revenues to 2056 as a % of GNP; central scenario; PAYG

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	4.4%	5.4%	7.2%	9.5%	12.8%	14.8%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Mandatory contributions	(3.4%)	(3.6%)	(3.8%)	(4.0%)	(4.0%)	(4.0%)
Public service pensions	1.1%	1.7%	2.4%	3.0%	3.2%	3.3%
NPRF	1.0%	1.0%	0.7%	(0.9%)	(2.7%)	(3.5%)
Tax relief on contributions	1.3%	1.4%	1.6%	1.6%	1.4%	1.4%
Tax relief on investment income	0.4%	0.4%	0.3%	0.3%	0.2%	0.2%
Tax revenue from pensions	(0.5%)	(0.5%)	(0.7%)	(0.9%)	(1.2%)	(1.2%)
Net cost to the Exchequer	0.6%	2.1%	4.0%	4.9%	6.0%	7.3%
Increase vs. current system	(1.9%)	(1.9%)	(1.6%)	(1.0%)	(0.3%)	0.3%

13.10 Effect on the national savings rate

The potential savings response under System 5 is potentially more predictable than the response under Systems 1 to 4. By guaranteeing better pensions under the first pillar, it is likely that savings will fall. If we assume that people are currently acting rationally and setting aside their preferred amount of funds for retirement, the improved guarantee under the first pillar reduces their need to save and so could lead to a fall in household savings.

There are two possible qualifications to this simple story. First, maybe people are not acting rationally with regard to pension savings. In this situation, people may not make the link between any new guarantee and their current savings behaviour and so may carry on as before. In this case, the predicted fall in savings may not occur to the full extent of the improved pension guarantee.

The second possible qualification arises if people switch pension-related savings into other forms of savings. The improved first pillar guarantee reduces the amount of savings needed to achieve a target retirement income. However, the funds that are then freed up may not be consumed but instead saved for other purposes. Again, saving may not fall by an amount equal to the improved pension. In this case, and in the case of the previous qualification, while the fall in savings may be lower than otherwise anticipated, a fall is still likely.

While savings at the household level may fall, the possibility remains for the Government to offset this fall by increasing the level of pension pre-funding. By taxing households and placing revenue in the NPRF, the government can maintain national savings levels even if household savings fall.

13.11 Summary

The obvious advantage of increasing the flat-rate Pillar 1 pension to 50% of average industrial earnings is that it is simple, easily understood and easily administered. It also automatically ensures that everyone earning up to the average industrial wage and retiring with a full entitlement to the OACP will have a replacement ratio of at least 50%. It is also the only one of the five alternative systems which will have a beneficial impact on existing pensioners – all of the other systems will only affect (to a greater or lesser extent) the pensions of future retirees.

However, there are also a number of drawbacks with this system. The first issue relates to the question of inter-generational equity. The proposed system would bring a substantial and immediate increase in the level of the flat-rate Pillar 1 benefit, thus increasing the cost of supporting the Pillar 1 system and exacerbating the pre-funding versus PAYG dilemma.

A once-off increase would also bring equity issues for members of occupational schemes which are integrated with Pillar 1. With integrated schemes, the level of pension paid from the scheme on retirement is determined according to the rules of the scheme and the level of the Pillar 1 pension at the date of retirement. This means that if you had two members of a scheme with identical career histories, salary progressions etc. but where one member retired the day before the increase in the OACP and the other retired the day after, the occupational pension payable to one member would be dramatically different to the pension payable to the other. This would suggest that a gradual, phased increase in the OACP would be required (although this would then negate the benefits of this system for existing pensioners referred to above). As an aside, introducing this system would, at a stroke, reduce or eliminate the deficits which are currently found in many defined benefit schemes (at least in respect of those schemes which are integrated).

From a quantitative perspective, the problem with this system is that the contribution rate which would be required to fund the increase in the OACP is very substantial. We have calculated that additional contributions of 9.2% (payable on all earnings) would be required. Clearly this would translate into a very considerable increase in PRSI which has potential implications for competitiveness and employment.

In summary:

Pros	Cons
Simple – easily understood	Expensive
Easily administered	Exacerbates Pillar 1 funding problems
Existing pensioners also benefit	Interaction with integrated schemes
	Impact on private-sector pension providers?

14 Summary

14.1 Current system

Before examining the five alternative systems put forward by the Pensions Board, we first examined the current system in terms of the projected development of the net Exchequer cost of the system (and hence its sustainability).

Our projections indicated that the overall net cost to the Exchequer of the current system is projected to increase almost threefold over the period to 2056.

	2006	2016	2026	2036	2046	2056
Projected cost of current system	2.5%	4.0%	5.6%	5.9%	6.3%	7.0%

The main driver of this overall increase is the projected increase in the cost of Pillar 1 and public service pensions: taken together, gross expenditure on these items is projected to increase from 4.3% of GNP to 13.8% of GNP over the period in question.

PRSI revenues are stable at 3.7% of GNP (taking credit for 85% of total PRSI revenues) and the NPRF is projected to defray costs by 3.5% of GNP by 2056.

The net cost of private sector Pillar 2 pensions (i.e. tax reliefs on contributions and investment returns, less tax revenues from pensions in payment) is projected to remain at 1.2% of GNP in 2056 (having first increased slightly in the intervening period).

The results were also examined on two alternative demographic scenarios – higher immigration and increased longevity post-2036. The latter had a small impact in the years after 2036, whereas the former had a larger impact with a projected net cost in 2056 of 5.7% rather than 7.0% of GNP.

14.2 Alternative System 1

Alternative System 1 – summary of key features

- May be characterised as an enhancement of the current voluntary supplementary system
- State flat-rate pension (contributory old age pension) of 34% of average industrial earnings.
- Enhancement to the voluntary supplementary pension system to allow tax credits on employee contributions at 42% (with an equivalent benefit for non-taxpayers).
- Restrictions on the maximum qualifying income and contributions for tax relief.

Alternative System 1 – projected net Exchequer cost						
	2006	2016	2026	2036	2046	2056
Projected costs of System 1	2.6%	4.2%	5.8%	6.0%	6.6%	7.2%
Increase vs. current system	0.1%	0.2%	0.2%	0.1%	0.3%	0.2%

Alternative System 1 – summary of our assessment

- This system involves relatively minor changes to the current system
- As a result, the cost to the Exchequer is likely to be relatively unchanged. On our assumption of increased pension coverage at the lower income levels, we projected that the net cost was likely to rise by approximately 0.2% of GNP per annum.
- In practice, it is debatable whether increased tax incentives for lower earners will have any impact on coverage levels.
- Note that our projections made no allowance for the potential savings to the Exchequer from the proposed curbs on tax relief for high earners (as they are likely to be relatively small). Our projections may slightly overstate the additional cost of this system, therefore.

14.3 Alternative System 2**Alternative System 2 – summary of key features**

- State flat-rate pension (contributory old age pension) of 34% of average industrial earnings.
- A mandatory supplementary defined contribution pension system, with equal contributions from employers and employees (5% each on earnings above the PRSI minimum up to a maximum of twice average industrial earnings).
- Further voluntary employer and employee contributions are permitted and qualify for tax credits as per Alternative System 1.

Alternative System 2 – projected net Exchequer cost

	2006	2016	2026	2036	2046	2056
Projected costs of System 2	3.0%	4.6%	6.2%	6.5%	6.7%	7.3%
Increase vs. current system	0.5%	0.6%	0.6%	0.6%	0.4%	0.3%

Alternative System 2 – summary of our assessment

- We project a slightly higher net Exchequer cost than under the current system (or Alternative System 1) because of the higher cost of public service pensions and the higher cost of tax relief with the introduction of mandatory contributions. Over time, however, this extra cost falls as the membership of voluntary schemes declines from current levels.
- We project relatively modest economic/competitiveness/employment impacts.
- The main advantage of this system (as with any mandatory system) is that it automatically provides universal coverage – the system is projected to deliver a coverage rate in excess of the NPPI target (i.e. over 70% of the labour force aged 30-64).
- However, there is the possibility that for many people the mandatory provision becomes their only provision, which leads to potential adequacy issues.
- There will be practical difficulties in integrating the mandatory system with the existing Pillar 2 system, especially in relation to public service pension arrangements. (This is not confined to this system but is true of any mandatory system which is introduced into an environment where there is already a voluntary Pillar 2 system.)
- A defined contribution system brings questions of investment risk and guarantees which will need to be considered.

14.4 Alternative System 3

Alternative System 3 – summary of key features

- As Alternative System 2 but with the mandatory defined contribution scheme operated by the State rather than by private-sector institutions.

Alternative System 3 – projected net Exchequer cost						
	2006	2016	2026	2036	2046	2056
Projected costs of System 3	3.0%	4.6%	6.2%	6.6%	6.8%	7.4%
Increase vs. current system	0.5%	0.6%	0.6%	0.7%	0.5%	0.4%

Alternative System 3 – summary of our assessment

- Our comments for Alternative System 3 are substantially as for System 2 (i.e. any general comments which apply to mandatory systems apply to this system).
- It is arguable that the question of providing investment performance guarantees becomes more acute in a State-run system. However, if the need for guarantees is accepted, why have a DC design at all – why not move to a System 4 style of system?
- The other comments on this system relate to the consideration of the pros and cons of State-run versus a privately-run system. These revolve around issues such as choice, trust, charges and political acceptability. The implications for private-sector pension providers would also need to be considered.

14.5 Alternative System 4

Alternative System 4 – summary of key features

- State flat-rate pension (contributory old age pension) of 34% of average industrial earnings.
- A mandatory supplementary State-run earnings related system, with equal contributions from employers and employees. The contribution rate would be set so as to be cost-neutral for the Exchequer in the long-term.
- Benefit of 1% of revalued annual pensionable earnings (defined as earnings above the PRSI minimum up to a maximum of twice average industrial earnings) for each year of contribution.
- Further voluntary employer and employee contributions are permitted and qualify for tax credits as per Alternative System 1.

Alternative System 4 – projected net Exchequer cost (funded)*						
	2006	2016	2026	2036	2046	2056
Projected costs of System 4	4.1%	5.3%	6.6%	6.8%	6.9%	7.3%
Increase vs. current system	1.6%	1.3%	1.0%	0.9%	0.6%	0.3%

* 'Funded' denotes that the mandatory earnings-related component of System 4 is assumed to be operated on a funded (rather than PAYG) basis.

Alternative System 4 – summary of our assessment

- As a system with a State-run mandatory component, many of the comments on Alternative System 3 apply equally to this system.
- The main difference between this system and Alternative System 3 is that one is a defined benefit system whilst the other is defined contribution.
- In comparing Systems 3 and 4, therefore, the choice boils down to a low contribution DC option or a high contribution DB option. System 4 is projected to result in a substantial increase (more than 70%) in private sector pension contributions.
- On a funded basis, the system is projected to result in an increase in the net Exchequer cost (but with the additional cost declining over time). On a PAYG basis, the system shows a much reduced net Exchequer cost over the entire projection period. This is illusory, however.
- However, the level of contributions required to fund the proposed benefit design of System 4 is unacceptable and is projected to have serious economic implications. A similar system with more modest benefits might be more acceptable.

14.6 Alternative System 5

Alternative System 5 – summary of key features

- State flat-rate pension (contributory old age pension) of 50% of average industrial earnings, with the additional cost of this benefit met by a separately identifiable contribution.
- Restrictions on the maximum qualifying income and contributions for tax relief.
- Otherwise no change to current system.

Alternative System 5 – projected net Exchequer cost (funded)*

	2006	2016	2026	2036	2046	2056
Projected costs of System 5	4.0%	5.6%	7.2%	7.4%	7.0%	7.1%
Increase vs. current system	1.5%	1.6%	1.6%	1.5%	0.7%	0.1%

* 'Funded' denotes that the *increase* in the Pillar 1 benefit is assumed to be operated on a funded (rather than PAYG) basis.

Alternative System 5 – summary of our assessment

- This system is probably the most simple, most easily understood and most easily administered of Systems 2 to 5.
- It also addresses the criticisms of the current pension system re inequitable allocation of State supports.
- It is also the only one of the five alternative systems which benefits the current generation of pensioners.
- There are, however, some practical issues around integration with existing Pillar 2 schemes which would need to be worked out.
- On a funded basis, the system is projected to result in an increase in the net Exchequer cost (but with the additional cost declining over time). On a PAYG basis, the system shows a reduced net Exchequer cost for many years into the future. This is illusory, however.
- The contribution is also relatively high, with consequent impacts on economic growth/competitiveness/employment etc. (System 5 is projected to result in an increase of approximately 50% in private sector pension contributions.)

14.7 Comparison of projected net Exchequer cost

Based on the assumptions and methodology as set out in this report, we project the following progression of net Exchequer costs for each of the systems.

Table 14.1: Projected net Exchequer cost for each system; % of GNP 2006-2056

	2006	2016	2026	2036	2046	2056
Current pension system	2.5%	4.0%	5.6%	5.9%	6.3%	7.0%
Alternative System 1	2.6%	4.2%	5.8%	6.0%	6.6%	7.2%
Alternative System 2	3.0%	4.6%	6.2%	6.5%	6.7%	7.3%
Alternative System 3	3.0%	4.6%	6.2%	6.6%	6.8%	7.4%
Alternative System 4 (funded)*	4.1%	5.3%	6.6%	6.8%	6.9%	7.3%
Alternative System 5 (funded)*	4.0%	5.6%	7.2%	7.4%	7.0%	7.1%

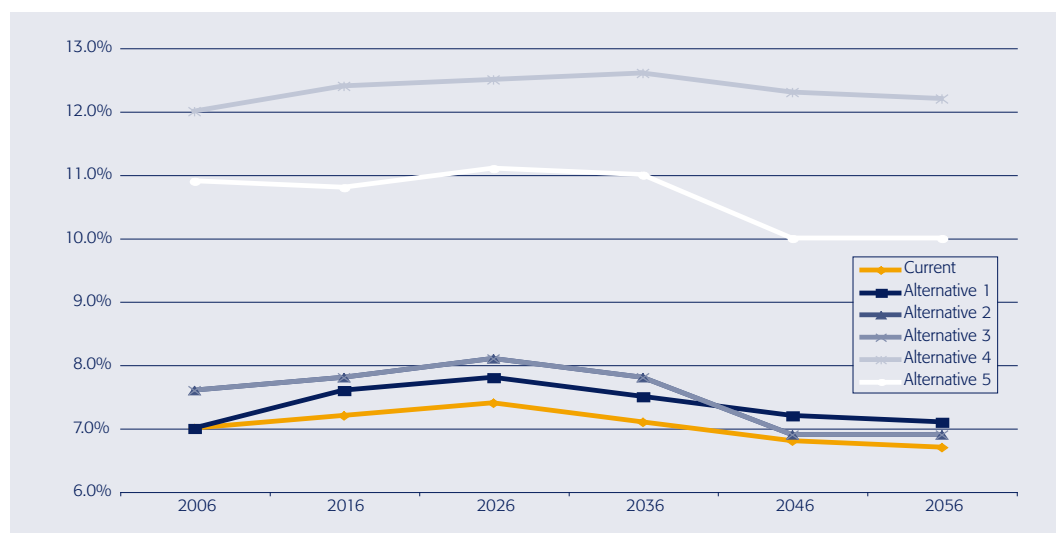
* 'Funded' denotes that the additional component (i.e. the mandatory earnings-related component of System 4 or the increase in the Pillar 1 benefit under System 5) is assumed to be operated on a funded (rather than PAYG) basis.

Very briefly, each of Alternative Systems 1 to 3 is projected to result in a relatively modest increase in the net cost to the Exchequer (in the range 0.1% to 0.6% of GNP p.a.). Systems 4 and 5, on the other hand, are projected to give rise to substantial additional net Exchequer costs in the short-term, but with the overall cost reverting in the long-term to a level close to that projected for the current system (reflecting the fact that the contribution rates required to pay for the additional components of these systems have been calculated so as to be 'cost neutral' in the long-term).

14.8 Comparison of projected contribution levels

Figure 14.1 shows the projected level of private sector pension contributions (excluding PRSI) under each of the alternative systems. As can be seen, Alternative Systems 4 and 5 would result in a very substantial increase in the level of contributions payable, with consequent economic implications.

Figure 14.1: Projected contributions (as % of labour force earnings) 2006-2056



Notes:

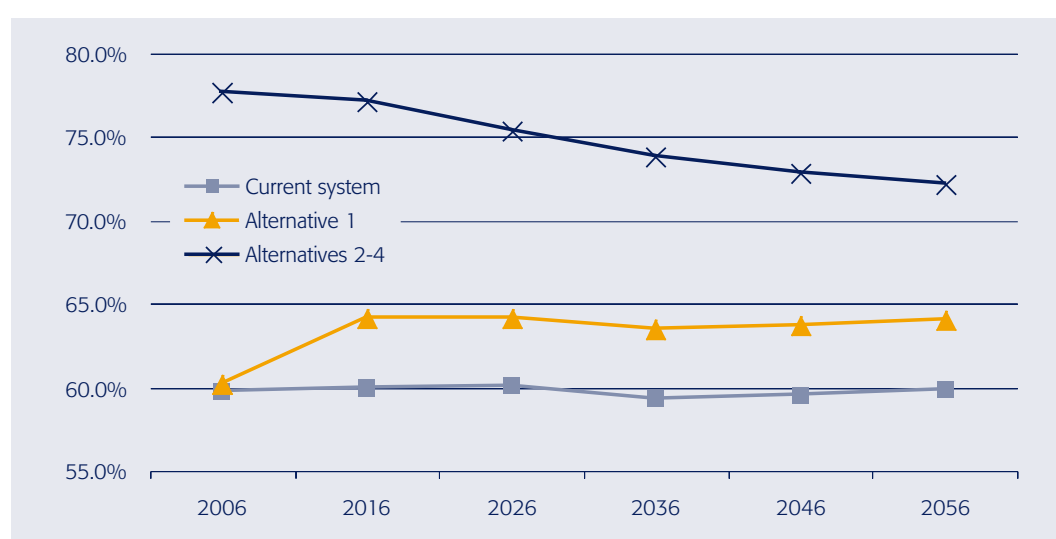
- Contributions include private-sector employer and employee contributions to Pillar 2 schemes (both voluntary and mandatory), public-sector mandatory employee contributions (where applicable) and, in the case of System 5, the additional private sector (employer and employee) and additional public-sector (employee only) contribution required to fund the proposed increase in the Pillar 1 pension.
- Figures are on the basis of the central demographic assumptions.

14.9 Comparison of projected coverage rates

Based on our assumptions, the projected coverage levels under each of the various systems (other than System 5)⁴⁰ are set out in Figure 14.2. It should be noted that these are not predictions – the projected coverage rates are a function of the agreed assumptions (see the comments in the notes to Figure 14.2 for details). Subject to that important caveat, it can be seen that only Alternative Systems 2, 3 and 4 (i.e. those with a mandatory component) are projected to meet the NPPI coverage target (i.e. at least 70% of the over-30 workforce).

It should also be noted that although the projected coverage levels for Alternatives 2, 3 and 4 are identical (by definition), the level of pensions payable under those systems – i.e. their adequacy – would be expected to differ (see 14.10 below).

Figure 14.2: Projected pension coverage rates (% of labour force aged 30-64)



Notes:

1. Figures include all Pillar 2 provision (public and private sector; voluntary and mandatory), but do not include Pillar 1 provision.
2. Figures are on the basis of the central demographic assumptions.
3. For Alternative System 1, projected coverage levels are a function of agreed assumptions (increased coverage at lower income levels). See 9.2 for details.
4. For Alternative Systems 2-4, projected coverage levels are affected by the agreed assumptions regarding the impact of mandatory pensions on voluntary coverage. See 10.2 for details.

14.10 Comparison of projected adequacy levels

Table 14.2 summarises the projected replacement rates (i.e. projected retirement income as a percentage of pre-retirement earnings, allowing for both Pillar 1 and mandatory Pillar 2 benefits) for those alternative systems which involve the introduction of a mandatory component or, in the case of System 5 an enhancement to the Pillar 1 benefit.

⁴⁰ The coverage rate for System 5 is not particularly meaningful (as almost everyone will receive the additional benefit of the increase in the Pillar 1 pension).

Table 14.2: Projected replacement rates under various alternative systems

	Earnings level (as % of gross average industrial earnings)			
	0.5 x GAIE	1.0 x GAIE	2.0 x GAIE	3.0 x GAIE
Alternative System 2	68%	42%	29%	19%
Alternative System 3	68%	43%	31%	20%
Alternative System 4	68%	55%	47%	32%
Alternative System 5	100%	50%	25%	17%

Notes:

1. The replacement rates have been calculated on the basis of a pension which is linked in payment to the growth in GAIE. Unisex annuity rates have been assumed.
2. For Systems 2 to 4, the replacement rates have been calculated assuming 40 years' contributions. For those already in the workforce, and particularly those close to retirement, these systems will deliver lower replacement rates.
3. The replacement rates for Systems 2 and 3 are not guaranteed; they will depend on the actual investment returns achieved. The rates quoted above have been calculated based on the assumption of a pre-retirement real return of 3.6% p.a. (before charges).

15 Appendix A

15.1 Summary of alternative systems for assessment

	Alternative System 1	Alternative System 2
	Enhancement of current voluntary supplementary system	Mandatory supplementary private system
Pillar 1 description	Contributory old age pension of 34% of average industrial earnings	Contributory old age pension of 34% of average industrial earnings
Pillar 2 description	Voluntary supplementary pension system	Mandatory supplementary pension system, comprising 5% employer/5% employee contributory (see notes below) to a maximum of twice average industrial earnings. Earnings below the current PRSI minimum will be exempt. Further voluntary employer and employee contributions permitted, and qualify for tax relief.
Tax treatment of employee contributions	Tax credit on employee contributions at 42%: equivalent benefit for non-taxpayers. Maximum qualifying income equal to current PRSA/RAC income limit.	Tax credit on employee contributions at 42%: equivalent benefit for non-taxpayers. Maximum qualifying income equal to current PRSA/RAC income limit.
Tax treatment of employer contributions	Employer contributions allowable as a business expense up to the PRSA/RAC limits.	Employer contributions allowable as a business expense up to the PRSA/RAC limits.
Tax treatment of investment returns	Tax free	Tax free
Tax treatment of pension benefits	As at present (i.e. pension benefits taxed as income)	As at present (i.e. pension benefits taxed as income)

Alternative System 3	Alternative System 4	Alternative System 5
Mandatory supplementary state defined contribution system	Mandatory supplementary state earnings related system	Enhanced basic pension, voluntary supplementary provision
Contributory old age pension of 34% of average industrial earnings	Contributory old age pension of 34% of average industrial earnings	Contributory old age pension of 50% of average industrial earnings. The additional cost of this benefit would be met by a separately identifiable charge.
Mandatory supplementary state defined contribution system, comprising 5% employer/5% employee contributory (see notes below) to a maximum of twice average industrial earnings. Earnings below the current PRSI minimum will be exempt.	Mandatory supplementary state earnings related system to a maximum of twice average industrial earnings. Earnings below the current PRSI minimum will be exempt. Benefit of 1% of revalued annual earnings for each year of contribution. The contribution rate would be calculated to be cost-neutral in the long-term, and would for projection purposes be divided equally between employees and employers.	Voluntary supplementary pension system
Further voluntary employer and employee contributions permitted, and qualify for tax relief.	Further voluntary employer and employee contributions permitted, and qualify for tax relief.	
Tax credit on employee contributions at 42%: equivalent benefit for non-taxpayers. Maximum qualifying income equal to current PRSA/RAC income limit.	Tax credit on employee contributions at 42%: equivalent benefit for non-taxpayers. Maximum qualifying income equal to current PRSA/RAC income limit.	Tax relief on employee contributions at marginal income tax rate. Maximum qualifying income equal to current PRSA/RAC income limit.
Employer contributions allowable as a business expense up to the PRSA/RAC limits.	Employer contributions allowable as a business expense up to the PRSA/RAC limits.	Employer contributions allowable as a business expense up to the PRSA/RAC limits.
Tax free	Tax free	Tax free
As at present (i.e. pension benefits taxed as income)	As at present (i.e. pension benefits taxed as income)	As at present (i.e. pension benefits taxed as income)

16 Appendix B

16.1 Detailed results on alternative demographic scenarios

In this Appendix we set out the detailed results for all systems and all demographic scenarios.

16.2 Current system

Table 16.1: Current system – projected costs and revenues to 2056 as a % of GNP; central scenario

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	3.0%	3.7%	4.9%	6.5%	8.7%	10.1%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions	1.0%	1.6%	2.2%	2.6%	2.8%	2.9%
NPRF	1.0%	1.0%	0.7%	(0.9%)	(2.7%)	(3.5%)
Tax relief on contributions	1.0%	1.1%	1.2%	1.1%	1.1%	1.1%
Tax relief on investment income	0.4%	0.5%	0.6%	0.7%	0.7%	0.7%
Tax revenue from pensions	(0.2%)	(0.2%)	(0.3%)	(0.4%)	(0.6%)	(0.6%)
Net cost to the Exchequer	2.5%	4.0%	5.6%	5.9%	6.3%	7.0%

Table 16.2: Current system – projected costs and revenues to 2056 as a % of GNP; higher immigration

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	3.0%	3.5%	4.6%	5.9%	7.7%	9.1%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions	1.0%	1.6%	2.0%	2.3%	2.4%	2.3%
NPRF	1.0%	1.0%	0.7%	(0.6%)	(2.3%)	(3.3%)
Tax relief on contributions	1.0%	1.1%	1.2%	1.2%	1.2%	1.2%
Tax relief on investment income	0.4%	0.5%	0.6%	0.7%	0.7%	0.7%
Tax revenue from pensions	(0.2%)	(0.2%)	(0.3%)	(0.4%)	(0.5%)	(0.6%)
Net cost to the Exchequer	2.5%	3.8%	5.1%	5.4%	5.5%	5.7%

Table 16.3: Current system – projected costs and revenues to 2056 as a % of GNP; increased longevity

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	3.0%	3.7%	4.9%	6.5%	8.8%	10.5%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions	1.0%	1.6%	2.2%	2.6%	2.8%	2.9%
NPRF	1.0%	1.0%	0.7%	(0.8%)	(2.6%)	(3.6%)
Tax relief on contributions	1.0%	1.1%	1.2%	1.1%	1.1%	1.1%
Tax relief on investment income	0.4%	0.5%	0.6%	0.7%	0.7%	0.7%
Tax revenue from pensions	(0.2%)	(0.2%)	(0.3%)	(0.4%)	(0.6%)	(0.6%)
Net cost to the Exchequer	2.5%	4.0%	5.6%	6.0%	6.5%	7.3%

16.3 Alternative System 1

Table 16.4: System 1 – projected costs and revenues to 2056 as a % of GNP; central scenario

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	3.0%	3.7%	4.9%	6.5%	8.7%	10.1%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions	1.0%	1.6%	2.2%	2.6%	2.8%	2.9%
NPRF	1.0%	1.0%	0.7%	(0.9%)	(2.7%)	(3.5%)
Tax relief on contributions	1.1%	1.3%	1.4%	1.3%	1.3%	1.3%
Tax relief on investment income	0.4%	0.5%	0.6%	0.7%	0.8%	0.7%
Tax revenue from pensions	(0.2%)	(0.2%)	(0.3%)	(0.5%)	(0.6%)	(0.6%)
Net cost to the Exchequer	2.6%	4.2%	5.8%	6.0%	6.6%	7.2%
Increase vs. current system	0.1%	0.2%	0.2%	0.1%	0.3%	0.2%

Table 16.5: System 1 – projected costs and revenues to 2056 as a % of GNP; higher immigration

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	3.0%	3.5%	4.6%	5.9%	7.7%	9.1%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions	1.0%	1.6%	2.0%	2.3%	2.4%	2.3%
NPRF	1.0%	1.0%	0.7%	(0.6%)	(2.3%)	(3.3%)
Tax relief on contributions	1.1%	1.3%	1.4%	1.4%	1.4%	1.4%
Tax relief on investment income	0.4%	0.5%	0.6%	0.7%	0.7%	0.7%
Tax revenue from pensions	(0.2%)	(0.2%)	(0.3%)	(0.4%)	(0.6%)	(0.6%)
Net cost to the Exchequer	2.6%	4.0%	5.3%	5.6%	5.6%	5.9%
Increase vs. current system	0.1%	0.2%	0.2%	0.2%	0.1%	0.2%

Table 16.6: System 1 – projected costs and revenues to 2056 as a % of GNP; increased longevity

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	3.0%	3.7%	4.9%	6.5%	8.8%	10.5%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions	1.0%	1.6%	2.2%	2.6%	2.8%	2.9%
NPRF	1.0%	1.0%	0.7%	(0.8%)	(2.6%)	(3.6%)
Tax relief on contributions	1.1%	1.3%	1.4%	1.3%	1.3%	1.3%
Tax relief on investment income	0.4%	0.5%	0.6%	0.7%	0.8%	0.7%
Tax revenue from pensions	(0.2%)	(0.2%)	(0.3%)	(0.5%)	(0.6%)	(0.7%)
Net cost to the Exchequer	2.6%	4.2%	5.8%	6.1%	6.8%	7.4%
Increase vs. current system	0.1%	0.2%	0.2%	0.1%	0.3%	0.1%

16.4 Alternative System 2

Table 16.7: System 2 – projected costs and revenues to 2056 as a % of GNP; central scenario

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	3.0%	3.7%	4.9%	6.5%	8.7%	10.1%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions	1.2%	1.8%	2.4%	2.8%	3.0%	3.1%
NPRF	1.0%	1.0%	0.7%	(0.9%)	(2.7%)	(3.5%)
Tax relief on contributions	1.3%	1.4%	1.4%	1.4%	1.2%	1.2%
Tax relief on investment income	0.4%	0.6%	0.8%	0.9%	1.0%	0.9%
Tax revenue from pensions	(0.2%)	(0.2%)	(0.3%)	(0.5%)	(0.8%)	(0.8%)
Net cost to the Exchequer	3.0%	4.6%	6.2%	6.5%	6.7%	7.3%
Increase vs. current system	0.5%	0.6%	0.6%	0.6%	0.4%	0.3%

Table 16.8: System 2 – projected costs and revenues to 2056 as a % of GNP; higher immigration

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	3.0%	3.5%	4.6%	5.9%	7.7%	9.1%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions	1.2%	1.8%	2.2%	2.5%	2.6%	2.5%
NPRF	1.0%	1.0%	0.7%	(0.6%)	(2.3%)	(3.3%)
Tax relief on contributions	1.3%	1.4%	1.4%	1.4%	1.2%	1.2%
Tax relief on investment income	0.4%	0.5%	0.7%	0.9%	0.9%	0.9%
Tax revenue from pensions	(0.2%)	(0.2%)	(0.3%)	(0.5%)	(0.7%)	(0.7%)
Net cost to the Exchequer	3.0%	4.3%	5.6%	5.9%	5.7%	6.0%
Increase vs. current system	0.5%	0.5%	0.5%	0.5%	0.2%	0.3%

Table 16.9: System 2 – projected costs and revenues to 2056 as a % of GNP; increased longevity

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	3.0%	3.7%	4.9%	6.5%	8.8%	10.5%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions	1.2%	1.8%	2.4%	2.8%	3.0%	3.1%
NPRF	1.0%	1.0%	0.7%	(0.8%)	(2.6%)	(3.6%)
Tax relief on contributions	1.3%	1.4%	1.4%	1.4%	1.2%	1.2%
Tax relief on investment income	0.4%	0.6%	0.8%	0.9%	1.0%	0.9%
Tax revenue from pensions	(0.2%)	(0.2%)	(0.3%)	(0.5%)	(0.8%)	(0.8%)
Net cost to the Exchequer	3.0%	4.6%	6.2%	6.6%	6.9%	7.6%
Increase vs. current system	0.5%	0.6%	0.6%	0.6%	0.4%	0.3%

16.5 Alternative System 3

Table 16.10: System 3 – projected costs and revenues to 2056 as a % of GNP; central scenario

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	3.0%	3.7%	4.9%	6.5%	8.7%	10.1%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions	1.2%	1.8%	2.4%	2.8%	3.0%	3.1%
NPRF	1.0%	1.0%	0.7%	(0.9%)	(2.7%)	(3.5%)
Tax relief on contributions	1.3%	1.4%	1.4%	1.4%	1.2%	1.2%
Tax relief on investment income	0.4%	0.6%	0.8%	1.0%	1.1%	1.1%
Tax revenue from pensions	(0.2%)	(0.2%)	(0.3%)	(0.5%)	(0.8%)	(0.9%)
Net cost to the Exchequer	3.0%	4.6%	6.2%	6.6%	6.8%	7.4%
Increase vs. current system	0.5%	0.6%	0.6%	0.7%	0.5%	0.4%

Table 16.11: System 3 – projected costs and revenues to 2056 as a % of GNP; higher immigration

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	3.0%	3.5%	4.6%	5.9%	7.7%	9.1%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions	1.2%	1.8%	2.2%	2.5%	2.6%	2.5%
NPRF	1.0%	1.0%	0.7%	(0.6%)	(2.3%)	(3.3%)
Tax relief on contributions	1.3%	1.4%	1.4%	1.4%	1.2%	1.2%
Tax relief on investment income	0.4%	0.6%	0.8%	0.9%	1.0%	1.0%
Tax revenue from pensions	(0.2%)	(0.2%)	(0.3%)	(0.5%)	(0.7%)	(0.8%)
Net cost to the Exchequer	3.0%	4.4%	5.7%	5.9%	5.8%	6.0%
Increase vs. current system	0.5%	0.6%	0.6%	0.5%	0.3%	0.3%

Table 16.12: System 3 – projected costs and revenues to 2056 as a % of GNP; increased longevity

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	3.0%	3.7%	4.9%	6.5%	8.8%	10.5%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions	1.2%	1.8%	2.4%	2.8%	3.0%	3.1%
NPRF	1.0%	1.0%	0.7%	(0.8%)	(2.6%)	(3.6%)
Tax relief on contributions	1.3%	1.4%	1.4%	1.4%	1.2%	1.2%
Tax relief on investment income	0.4%	0.6%	0.8%	1.0%	1.1%	1.1%
Tax revenue from pensions	(0.2%)	(0.2%)	(0.3%)	(0.5%)	(0.8%)	(0.9%)
Net cost to the Exchequer	3.0%	4.6%	6.2%	6.7%	7.0%	7.7%
Increase vs. current system	0.5%	0.6%	0.6%	0.7%	0.5%	0.4%

16.6 Alternative System 4 (funded basis)⁴¹

Table 16.13: System 4 – projected costs and revenues to 2056 as a % of GNP; central scenario

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	3.0%	3.7%	4.9%	6.5%	8.7%	10.1%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions	1.7%	2.2%	2.8%	3.2%	3.4%	3.5%
NPRF	1.0%	1.0%	0.7%	(0.9%)	(2.7%)	(3.5%)
Tax relief on contributions	1.9%	2.0%	2.0%	2.0%	2.0%	2.0%
Tax relief on investment income	0.4%	0.3%	0.2%	0.2%	0.1%	0.1%
Tax revenue from pensions	(0.2%)	(0.2%)	(0.3%)	(0.5%)	(0.9%)	(1.2%)
Net cost to the Exchequer	4.1%	5.3%	6.6%	6.8%	6.9%	7.3%
Increase vs. current system	1.6%	1.3%	1.0%	0.9%	0.6%	0.3%

Table 16.14: System 4 – projected costs and revenues to 2056 as a % of GNP; higher immigration

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	3.0%	3.5%	4.6%	5.9%	7.7%	9.1%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions	1.7%	2.2%	2.5%	2.8%	2.9%	2.8%
NPRF	1.0%	1.0%	0.7%	(0.6%)	(2.3%)	(3.3%)
Tax relief on contributions	1.9%	2.0%	2.1%	2.1%	2.0%	2.0%
Tax relief on investment income	0.4%	0.3%	0.2%	0.1%	0.1%	0.1%
Tax revenue from pensions	(0.2%)	(0.2%)	(0.3%)	(0.5%)	(0.8%)	(1.0%)
Net cost to the Exchequer	4.1%	5.1%	6.1%	6.1%	5.9%	6.0%
Increase vs. current system	1.6%	1.3%	1.0%	0.7%	0.4%	0.3%

Table 16.15: System 4 – projected costs and revenues to 2056 as a % of GNP; increased longevity

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	3.0%	3.7%	4.9%	6.5%	8.8%	10.5%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions	1.7%	2.2%	2.8%	3.2%	3.4%	3.5%
NPRF	1.0%	1.0%	0.7%	(0.8%)	(2.6%)	(3.6%)
Tax relief on contributions	1.9%	2.0%	2.0%	2.0%	2.0%	2.0%
Tax relief on investment income	0.4%	0.3%	0.2%	0.2%	0.1%	0.1%
Tax revenue from pensions	(0.2%)	(0.2%)	(0.3%)	(0.5%)	(0.9%)	(1.2%)
Net cost to the Exchequer	4.1%	5.3%	6.6%	6.9%	7.1%	7.6%
Increase vs. current system	1.6%	1.3%	1.0%	0.9%	0.6%	0.3%

⁴¹ The mandatory earnings-related component is assumed to be operated on a funded (rather than PAYG) basis.

16.7 Alternative System 5 (funded basis)⁴²

Table 16.16: System 5 – projected costs and revenues to 2056 as a % of GNP; central scenario

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	4.4%	5.3%	6.6%	8.0%	9.8%	10.6%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions	1.1%	1.7%	2.4%	3.0%	3.2%	3.3%
NPRF	1.0%	1.0%	0.7%	(0.9%)	(2.7%)	(3.5%)
Tax relief on contributions	1.3%	1.4%	1.6%	1.6%	1.4%	1.4%
Tax relief on investment income	0.4%	0.4%	0.3%	0.3%	0.2%	0.2%
Tax revenue from pensions	(0.5%)	(0.5%)	(0.7%)	(0.9%)	(1.2%)	(1.2%)
Net cost to the Exchequer	4.0%	5.6%	7.2%	7.5%	7.0%	7.1%
Increase vs. current system	1.5%	1.6%	1.6%	1.5%	0.7%	0.1%

Table 16.17: System 5 – projected costs and revenues to 2056 as a % of GNP; higher immigration

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	4.4%	5.0%	6.2%	7.3%	8.7%	9.5%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions	1.1%	1.7%	2.2%	2.6%	2.7%	2.6%
NPRF	1.0%	1.0%	0.7%	(0.6%)	(2.3%)	(3.3%)
Tax relief on contributions	1.3%	1.4%	1.5%	1.6%	1.4%	1.4%
Tax relief on investment income	0.4%	0.3%	0.3%	0.3%	0.2%	0.2%
Tax revenue from pensions	(0.5%)	(0.5%)	(0.6%)	(0.8%)	(1.0%)	(1.0%)
Net cost to the Exchequer	4.0%	5.2%	6.6%	6.7%	6.0%	5.7%
Increase vs. current system	1.5%	1.4%	1.5%	1.3%	0.5%	0.0%

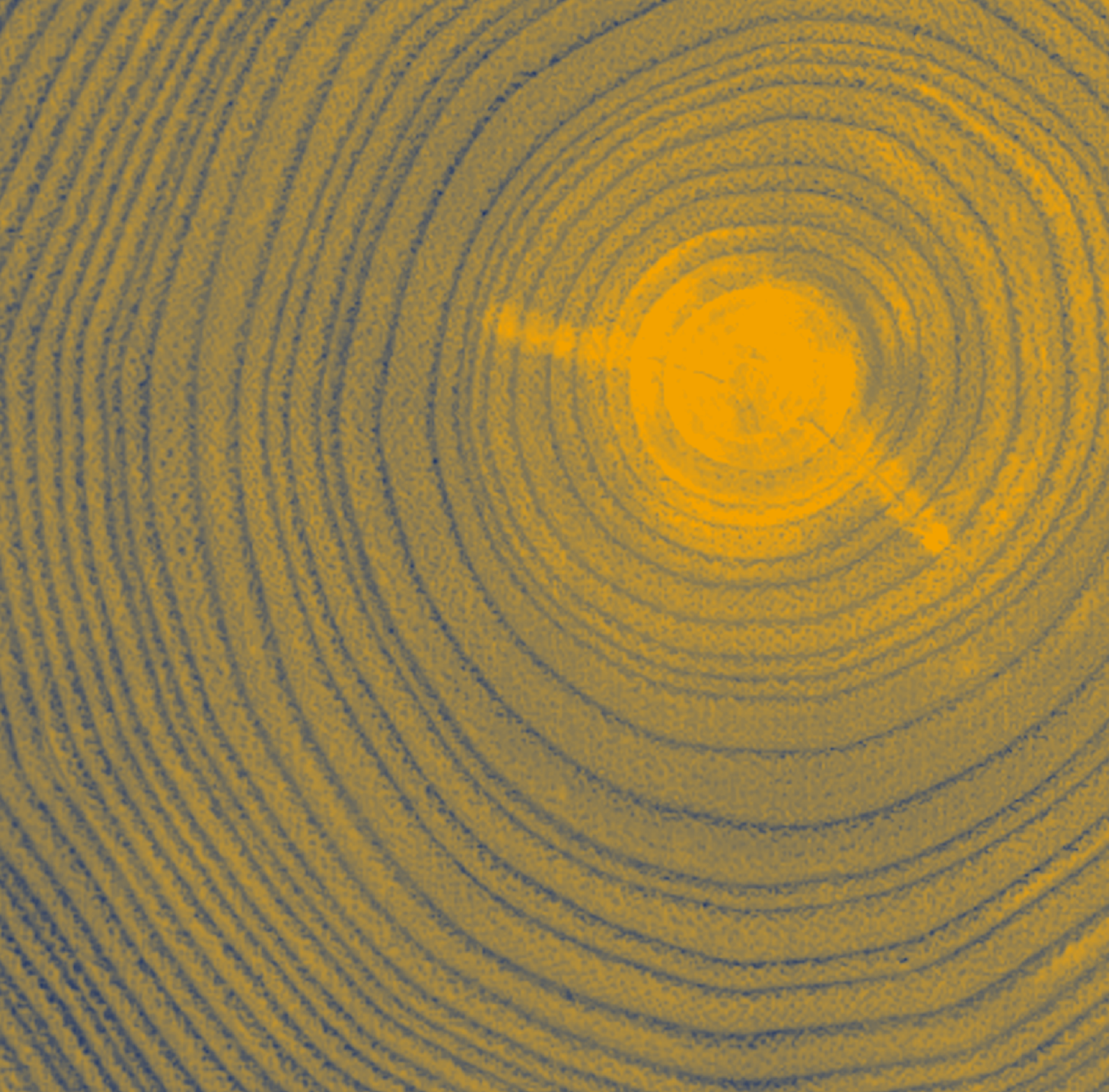
Table 16.18: System 5 – projected costs and revenues to 2056 as a % of GNP; increased longevity

	2006	2016	2026	2036	2046	2056
Pillar 1 pensions	4.4%	5.3%	6.6%	8.0%	9.9%	11.1%
PRSI revenues	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)	(3.7%)
Public service pensions	1.1%	1.7%	2.4%	3.0%	3.2%	3.3%
NPRF	1.0%	1.0%	0.7%	(0.8%)	(2.6%)	(3.6%)
Tax relief on contributions	1.3%	1.4%	1.6%	1.6%	1.4%	1.4%
Tax relief on investment income	0.4%	0.4%	0.3%	0.3%	0.2%	0.2%
Tax revenue from pensions	(0.5%)	(0.5%)	(0.7%)	(0.9%)	(1.2%)	(1.3%)
Net cost to the Exchequer	4.0%	5.6%	7.2%	7.5%	7.2%	7.4%
Increase vs. current system	1.5%	1.6%	1.6%	1.5%	0.7%	0.1%

42 The increase in the Pillar 1 benefit is assumed to be operated on a funded (rather than PAYG) basis.

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APPENDIX 7

HEWITT ASSOCIATES REPORT ON POSSIBLE STATE INVOLVEMENT IN SECOND PILLAR PROVISION

SEPTEMBER 2005

APPENDIX 7 – HEWITT ASSOCIATES REPORT ON POSSIBLE STATE INVOLVEMENT IN SECOND PILLAR PROVISION

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Introduction

Introduction

This report has been commissioned by the Pensions Board as part of the National Pensions Review instigated by the Minister for Social and Family Affairs. The report considers the advantages and disadvantages of possible State involvement in pension provision at retirement under the Second Pillar i.e. occupational and personal pension schemes.

Why has this become an issue?

Traditionally, under personal pension arrangements i.e. retirement annuity contracts and personal retirement bonds, income in retirement was provided by applying the balance of the capital accumulated after taking any tax free lump sum to purchase an annuity. Similar provisions applied to benefits arising under defined contribution occupational pension schemes.

Whilst the introduction of Approved Retirement Funds in 1999 has provided some flexibility for proprietary directors and in respect of funds arising from Additional Voluntary Contributions to occupational pension schemes, and for those with personal pensions and PRSAs, there is still a requirement to purchase an annuity in other cases.

In defined benefit schemes, trustees may elect to pay pensions to retired members from the scheme assets rather than purchase an annuity at retirement. This has generally been the case for larger schemes but is increasingly common for smaller schemes, notwithstanding the significant investment and longevity risk being taken on. However, the level of annuity prices also affects defined benefit schemes through the operation of the funding standard in Part IV of the Pensions Act. In assessing the liability for pensions in payment for the purpose of the funding standard, the actuary is required to use the market cost of purchasing annuities to meet these liabilities. This includes the provision of future fixed or index linked pension increases guaranteed under the rules of the scheme.

Annuity costs have increased substantially in recent years (see Appendix A) due primarily to historically low nominal and real bond yields, and the allowance being made by insurers in pricing annuities for improvements and anticipated further improvements in mortality. As a consequence, the level of income which can be now be obtained by purchasing an annuity appears very unattractive compared with the capital sum which would have to be paid over to the insurer to secure this income. Similarly, for defined benefit schemes with a significant pensioner membership, the funding standard liabilities have increased dramatically over a period when equity markets have performed poorly. Pension schemes which were substantially invested in equities over that period are now unable to satisfy the funding standard leading to increased contribution rates, benefit reductions and scheme closure.

The State as an annuity provider

Against this background, it has been suggested that the State should provide annuities in a number of different contexts. These are discussed in the next section, following which we analyse the proposals and discuss the likely impact of the introduction of a State annuity purchase facility.

Background to Proposals

Background

The proposal that the State set up an annuity purchase scheme has arisen in a number of different contexts:

- a) as part of a proposed revised funding standard that might be applied to fund defined benefit schemes.

This is discussed further below

- b) as part of a proposed new public sector wide new AVC scheme called SPEARS, whereby public servants would be entitled to exchange AVC capital for a set amount of public sector pension, to be increased in line a Public Service Earnings Index.

This, it is suggested, is similar in nature to the State's existing facility for public servants to buy back notional service (and hence additional public service pension) in return for AVC contributions, either ongoing or once off. This is outside the scope of this report.

- c) as part of an equity release scheme where certain pensioners might be able to mortgage or sell a reversionary interest in part of their principal private residence to the State, in return for an additional level of Social Welfare Old Age Pension.

This is outside the scope of this report.

- d) as a more general '*social protection*' measure, to provide additional security to members of defined contribution pension arrangements by providing a guaranteed exchange of capital at retirement for an inflation protected pension.

For example, it has been proposed that the State might provide a set level of supplementary Social Welfare pension, up to a certain maximum level, in return for a given level of retirement capital. This is also discussed further below.

Financial basis for State Annuity Fund

In the case of (a), (b) and (c) above it has been proposed that the State Annuity Fund ("SAF") would be fiscally neutral, over the longer term, to the Exchequer. The SAF in setting its terms would therefore take a view on future long-term investment returns, rates of inflation or earnings growth as relevant, mortality and the expenses of operating the scheme, with the intention over the longer term of balancing the Fund's income and outgo.

However the SAF would, if it is to guarantee benefits to its annuitants, have to operate under an Exchequer guarantee so that if the anticipated assumptions (for example the rate of future investment return), used to set the annuity terms are not achieved in practice the Exchequer would make up the difference to prevent the Fund itself becoming insolvent and defaulting on its obligations to annuitants. There could therefore be a potential exposure for the Exchequer if the assumptions made in setting the terms of the SAF are not achieved.

In the case of (d), i.e. the social protection proposal, it is implicit in its description that there would be some element of long-term Exchequer support or subsidy as the proposal suggests that the facility be restricted in quantum by targeting it mainly at the lower paid.

Why should the State act as annuity provider?

The main reasons put forward for the State to act as an annuity provider are:

- it could provide better terms than commercial annuity providers, as
 - the State would be a 'not for profit' provider,
 - the State fund could invest in a broader range of investment asset classes than commercial annuity providers who are forced to invest mainly in Bonds to match their liabilities. This wider investment policy would, it is anticipated, achieve a superior return over the long-term than Bonds.

- there would be no risk of insolvency or failure as might exist for commercial annuity providers, assuming the State Annuity Fund carried an ultimate State guarantee.
- Only the State could guarantee to pay certain types of pensions, e.g. a Public Service earning linked pension or a supplementary Social Welfare Old Age Pension. There are not suitable assets available for investment that would match the nature of these annuity liabilities.
- it would provide certainty of supply.
- Commercial annuity providers are not obliged (other than in respect of insured pension contracts they may have issued themselves under which they guaranteed to provide a certain minimum level of annuity at retirement) to offer annuities all the time or at any time.
- For example, some life companies who offer cash accumulation 'retirement annuities' do not in fact undertake in their retirement annuity contract to convert this cash to pension at retirement; rather such contracts offer only an open market annuity option at retirement where an annuity is required by the retiree.

Review of the Funding Standard

The Pensions Board undertook a review of the funding standard last year and reported to the Minister in December 2004. Although consideration was given to proposals to move away from annuity costs as the basis for placing a value on pensioner liabilities, the Board did not recommend any change in this area, and no change has subsequently been made. The rationale for this was that if a scheme were to wind up, pensioners who have first priority (after expenses and AVCs) should have their benefits secured on a guaranteed basis, and a funding standard which was not linked to annuity prices would not provide sufficient security for pensioners.

The Review also considered the possible establishment of a "State Annuity Fund" (SAF) which would be available to provide annuities for pensioners of defined benefit schemes which wound up, and which would offer better rates than commercial providers, for reasons which are discussed later. This would lower the funding standard liabilities and mitigate to some extent the contribution increases and benefit reductions arising from the current high cost of annuities. In the event of a scheme wind-up, pensioners would have their benefits provided from the SAF on a guaranteed basis (assuming the pension scheme assets were sufficient to meet the cost of these as assessed by the SAF).

Social Protection measure

In addition to the perceived benefits for funding defined benefit schemes, the SAF could be made available to members of defined contribution arrangements, including PRSAs, who were required to purchase an annuity at retirement. A paper by James R. Kehoe entitled "Pension Provision in Ireland – The Shape of Things to Come?" presented at a seminar held by the Society of Actuaries in Ireland in April 2003, set out proposals for State involvement in Second Pillar provision. In particular, he proposed

- a limited option to supplement Social Welfare Pension
- a "value for money" State underpin for standard PRSAs
- a new funding standard for defined benefit schemes which prioritised benefits up to monetary limits

The proposals in relation to the funding standard were considered as part of the Pensions Board Review but were not adopted. In this report, we consider further the first 2 proposals listed above.

Outline of Proposals Considered

Introduction

The fundamental question is whether the State should get involved at all in Second Pillar pension provision at retirement, and a secondary question, if the answer to the first question is yes, is to what extent? The answer to the first question may be impacted by the issues raised by the second question and accordingly it is necessary to set out the scope of the possible involvement of the State.

Proposals considered

If the State were to become involved in income provision at retirement for Second Pillar pension arrangements, this facility could be made universally available i.e. the State would become an annuity provider in competition with the insurance companies who currently sell annuities or it could be restricted in scope to

- those retiring from specified arrangements e.g. Standard PRSAs
- specific circumstances e.g. involuntary scheme wind-up
- benefits up to certain limits e.g. the prevailing level of State pension

As set out in the Board's specification for this project, we consider the following proposals

- making the SAF available only to provide pensions for members of DB schemes which have gone into involuntary wind-up
- making the SAF available only to provide pensions for members of all DB schemes which have gone into wind-up
- making the SAF available to all pension schemes, PRSAs and RACs, possibly up to a maximum amount

Why restrict the scope of the SAF?

The third option listed above includes the possibility of the SAF being available to all, with no maximum amount. Before addressing the proposals in detail, we consider in broad terms some of the issues which would arise in the context of universal availability of State annuities.

The arguments for making the SAF universally available include

- if the SAF enables more efficient conversion of capital to income in retirement, why restrict its availability?
- the availability of ARFs (particularly if this is extended) will limit the extent to which those retiring will want to buy an annuity, even on relatively generous terms
- it may in practice be difficult to restrict the option as intended e.g. multiple policies, deliberate triggering of wind-up in deficit etc.

However, it can be argued that there are a number of advantages in limiting the scope of the SAF to specified cases

- it would reduce the risk to the State and the burden on the Exchequer
- the impact on the annuity market would be lessened
- if restricted to lower levels of income, or members of schemes which go into involuntary wind-up, the measure could be justified as a social protection measure
- there may be less risk of a challenge from the EU in relation to State subsidies

Proposal 1

“The SAF should provide pensions to retired members of DB schemes which go into involuntary wind-up in exchange for lump sums.”

This reflects the proposal set out in a discussion document prepared by the IAPF entitled “The Advantages of a State Backed Annuity Purchase Scheme in the Context of the Current Funding Standard”. This paper advocates an alternative to the current funding standard whereby the trustees, employer and Pensions Board agree to a “long-term” funding standard in return for a commitment by the employer to make good any shortfall on wind up. In the event of wind-up when the employer is insolvent, the State annuity purchase facility would be available. The IAPF envisaged that the scheme actuary would assess the level of assets needed to provide the pensions on a long-term basis and this amount would be transferred to the State to provide retirement income for the pensioners, administered by a third party provider.

For the purpose of this analysis, we have taken “involuntary wind-up” to mean that the sponsoring employer is insolvent and the trustees are required to wind-up the scheme as a consequence. There may be other circumstances where trustees have to wind-up a scheme because of provisions in the scheme documentation e.g. if the employer (although solvent) gives notice that he intends to cease contributing. However, we understand that it is not proposed that the SAF would be available in such cases.

Under this proposal the SAF would not be available if the assets of the Scheme were sufficient to provide benefits in accordance with the provisions of Section 43 of the Act, with annuities being purchased in the market for pensioners, whether the employer were insolvent or otherwise. If the SAF were available in such cases, and provided cheaper annuities than insurance companies, the end result could be that a surplus would be returned to the company or liquidator which would not appear to be desirable.

Accordingly, we understand that this proposal would apply only where a scheme was winding up as a consequence of insolvency of the employer, and with insufficient assets to meet the wind-up benefits in full if annuities had to be purchased in the market. We also presume that if the use of the SAF moved the fund from a deficit to a surplus the availability of the SAF would be restricted in some way to ensure that this surplus did not arise.

A number of possible scenarios exist

1. The assets could provide 100% of pensions (on market annuity basis) and say 40% of benefits for others. If the SAF provided cheaper annuities, the pensioners would be unaffected but the others might see an increase to say 70% of their benefits
2. The assets could provide say 80% of pensions (on market annuity basis) and nothing for others. If the SAF provided cheaper annuities, the pensioners might increase to 100% but the others might still not get anything
3. The assets could provide 50% of pensions (on market annuity basis) and nothing for others. If the SAF provided cheaper annuities, the pensioners might get an increase to say 75% of their pensions but others would still get nothing.

It can be seen that the impact of the SAF on different categories of member would vary depending on the level of underfunding of the scheme. This is a function of the priority order rather than of the SAF, but it might lead to pressure from the lower priority classes to receive some benefit from the existence of the SAF. Indeed, one would expect that the availability of the SAF in such cases would be misinterpreted as a State insurance system to provide full benefits on the wind up of a scheme.

It would be necessary for the SAF to be able to provide an annuity which matched the benefit promise to the individual. Different schemes (and in some cases different members of the same scheme) might have different escalation provisions, different spouse's pensions attaching, different payment dates etc and this would create some added complexity, although this would be mitigated if as proposed by the IAPF the costing were performed by the scheme actuary and the benefits were paid by a third party administrator or payroll provider.

Proposal 2

"The SAF should provide pensions to retired members of all DB schemes in wind-up in exchange for lump sums."

This is an extension of Proposal 1 above to schemes which wind up other than in circumstances where the employer is insolvent, and where the assets are insufficient to provide benefits using the annuity market.

This would give employers the opportunity to wind up their existing DB schemes and "dump" the pensioner liabilities on the State at a reduced cost relative to the market annuity cost which they have to fund for under the current funding standard. For schemes which have a surplus relative to the current funding standard, the availability of the SAF would increase the surplus which would be applied in accordance with the scheme rules, usually by augmentation of benefits and/or a refund to the employer.

We do not suggest that all companies would take advantage of this opportunity to terminate their DB schemes and there are many other issues which would have to be addressed to enable this to happen. However, one expects that there would be some such cases. For those employers who are committed to DB provision, the impact in practice of this proposal would be to reduce the value of pensioner liabilities under the current funding standard, thereby enabling schemes to meet the funding standard more easily and reducing the level of employer contributions required.

One might also expect that trustees would be less likely to purchase annuities as members retire (assuming the SAF was not available in such circumstances) as this would create a funding strain relative to the SAF based funding standard liability and the trustees would be more relaxed about carrying the risk if there were "guaranteed" SAF rates available on wind-up.

Proposal 3

"The SAF should provide pensions to all pension schemes, PRSAs and RACs, possibly up to a maximum amount."

Assuming that a maximum limit is imposed in all circumstances, equal possibly to the prevailing level of State pension, this would limit the extent to which some of the benefits of Proposals 1 and 2 and some of the problems identified under them would arise in practice. In particular, an ongoing employer with a scheme which paid pensions well in excess of the maximum limit would probably find that the savings arising from winding up the scheme (as suggested in our analysis of Proposal 2) would not be significant. Similarly the impact on the funding standard and the required contribution levels would be reduced. However, for schemes with a lot of small pensions below the maximum limit, the benefits identified earlier would still arise.

The existence of the limit would complicate the actual winding up of a scheme in deficit, as it would first be necessary to buy the lesser of the full entitlement and the limit with the SAF and then the excess over the limit in the market in order to determine the assets available for others. If the assets were not sufficient to provide in full for pensions in payment (even using the SAF for the bottom slice of pension), there would need to be clarity as to how the deficiency was apportioned. The simplest approach would seem to be for the bottom slice to have higher priority than the rest (as per the proposal put forward by James R Kehoe, which was considered as Option C in the Pensions Board's Review of the Funding Standard.)

The availability of the SAF to those retiring from DC schemes, or with PRSAs or RACs, would presumably result in annuities which are currently purchased from commercial insurers being bought from the SAF. It is not clear that many of those who currently elect for an ARF (or who would do so if this facility were extended) would change this decision even if an annuity up to a certain limit were available on significantly better terms).

The payment of pensions would also become more complicated, as the pensioner would receive pension from two sources. However, with increasing mobility of labour this is already the case for some pensioners. In any event, as the individual will (assuming he or she has attained State Pension Age and paid or was credited with sufficient PRSI contributions) be in receipt of a State First Pillar pension, it may be possible to add the payment from the SAF to this to minimise administration and inconvenience for pensioners.

Minimum proposals

Whilst we appreciate that the State may wish to limit the availability of the SAF for the reasons noted above, we thought it would be helpful to identify the minimum extent to which it would be worth introducing this facility. This might enable the State to “dip its toe in the water” without committing to any extension of this facility at a later date, although if it is perceived to be a good thing there would undoubtedly be political pressure to do so, as with ARFs.

There are 2 separate strands to the proposal for a State annuity fund, and we believe it would be helpful to distinguish these as it may be considered appropriate to introduce one but not the other, or possibly both but on different bases.

The first applies only to DB schemes and is part of a proposal put forward by the IAPF to amend the funding standard for some schemes. This proposal has already been considered by the Board in its review of the funding standard. If introduced as part of an amendment to the funding standard, it would enable more DB schemes to continue, which we believe would be in line with policy objectives. In practice, there might be relatively few cases where the State was called on to provide annuities, and the pricing and establishment of these might not be overly onerous if dealt with in the way suggested by the IAPF.

The second proposal in relation to DC arrangements is the State Option put forward by James R Kehoe which provides a facility for those with modest accumulated retirement funds to pass these to the State in return for a guaranteed addition to their Social Welfare pensions (within a certain limit). We suggest that the rationale for this proposal is to enable DC savers, to access retirement income in a secure, cost effective and administratively efficient way. This is essentially a social protection issue and may be expected to encourage greater voluntary take up of pension saving by lower earners. If implemented, this approach would require greater commitment of resources by the State as the “shop” would always have to be open for business and would be dealing with individuals rather than pension scheme trustees or administrators. It would also be expected that the number of annuities established over the medium term would be greater than under the above proposal.

We suggest that consideration of an SAF should focus on these 2 minimum proposals as additional issues arise if the availability of SAF is broadened. We consider also that it may be appropriate to have 2 different structures if both proposals are implemented, although this would add to the complexity and could lead to claims of unfair treatment as between DC and DB members.

Impact on current and potential pension provision

Introduction

In this section we look at the impact of the involvement of the State in pension provision on individuals, and on trustees and sponsoring employers of occupational pension schemes.

Existing PRSA, RAC and PRB holders

If the involvement of the State were limited to offering annuities (potentially limited to a maximum annual amount) on better terms than are available in the market, one might expect that this would have some impact on the level of contribution which would be made to such arrangements. This might be arise not just because of the better terms which are available, but because of a higher level of confidence and trust in the State than in insurance companies. However, the extent of the increase in contributions could be relatively small because

Those some way from retirement (e.g. below 40) have little understanding of how their pension will be delivered in retirement and are more driven by current spending requirements and tax relief

Those who would have the option to transfer their funds to an ARF at retirement are likely to choose this option even if significantly better annuity rates are available from the SAF

Those who are already projected to receive income in excess of the maximum limit covered by the SAF would not have any incentive to save more than they currently do

This suggests that those who are most likely to increase pension saving if the SAF were available are those relatively close to retirement, with relatively modest accumulated funds and no facility to ARF these at retirement. This is precisely the group for whom the State Underpin proposed by James R Kehoe would provide a guarantee of investment returns pre retirement and the effect of both of these could be to significantly increase savings to Standard PRSAs at the older ages.

If there is no State Underpin, or for those who do not benefit from it if there is, the investment strategy to be followed by an individual with a DC arrangement if he or she intends to buy an annuity from the SAF will require consideration and advice. Presumably Standard PRSAs will default to such a strategy.

Existing Members of DC schemes

Additional savings would take the form of AVCs which could be ARFed if the main scheme benefits plus the State pension are sufficient to meet the income requirement for ARFs. Hence it is not clear that individuals will contribute more because of the availability of the SAF.

Existing Members of DB schemes

For pensioners, the existence of the SAF might provide some added comfort regarding the security of their benefit. In actual wind-ups, pensioners are first priority liabilities so this will not be significant in many cases. However, for active members and deferred pensioners it will be of significance.

Paradoxically, if the funding standard is made less onerous by the availability of State annuities, the amount of contribution going into schemes will reduce, which in itself lessens the security of members' benefits! Against this, however, must be set the likelihood that fewer DB schemes would close if the funding standard were weakened.

In any event, the existence of the SAF will not of itself encourage members to pay AVCs as there are normally taken as cash or transferred to an ARF at retirement.

Those without pensions at present

This group are likely to be relatively young and low paid, so in general they would benefit from the existence of an SAF. However, as with the first group above, they are likely to have little understanding of how their pension will be delivered in retirement and are more driven by current spending requirements and tax relief.

If following the Review, it becomes mandatory for individuals to contribute to a DC pension arrangement (either State operated or privately operated), it may be considered necessary to offer guaranteed conversion rates at retirement at least in respect of part of the accumulated funds under such arrangements.

Trustees

Trustees would welcome the existence of the SAF as an additional way of securing benefits on wind-up, which is cheaper than those currently available. Trustees of DB schemes would be less likely to buy annuities in the market for retirees.

If the SAF were generally available on retirement, Trustees of DB schemes would have to give some consideration to their investment strategy if the SAF did not price annuities on a market related basis i.e. what assets should be held to best match liabilities which will be secured with the SAF?

Employers

Employers who operate DC schemes will not see any direct benefit from the existence of the SAF. However, if it is introduced in such a way that it effectively eases the funding standard, employers with relatively mature DB schemes should see some reduction in their contribution requirements and in some cases this may enable DB provision to be maintained where it would otherwise cease. If it is available on wind up even where the employer is solvent, the option of winding up the DB scheme will become more attractive.

Impact on the State

Introduction

This section considers the impact on the State if a SAF were introduced and considers how it might work.

Financial impact

The State currently pays First Pillar pensions and public sector pensions totalling €5.6bn per annum. These pensions are currently paid from the Exchequer on a pay as you go basis. The National Pensions Reserve Fund will meet part of these liabilities from 2025 onwards and it will be funded to the extent of 1% per annum of GNP up to that date.

The proposed SAF would receive lump sums from individuals at retirement or from trustees of schemes which were winding up. These could be treated as Exchequer receipts or could be invested in a separate fund. In return, the SAF would make weekly or monthly payments to the individual for the remainder of his or her lifetime.

In the short-term therefore, the impact on the State's finances would be positive as the lump sums received would be considerably higher than the income paid out. This would be the case even if the SAF rates were subsidised. However, unless a policy decision were made that these rates should be subsidised explicitly from the Exchequer, it would be prudent to price the annuities on the basis that they would be cost neutral in the long-term. Even if this is done at issue of the annuities, it may be necessary to subsidise the SAF by transfers from the Exchequer if the pricing assumptions are not borne out in practice. This would require regular reviews of the SAF (rather like the reviews of the Social Welfare Fund and Public Sector pensions which are currently carried out) and an assessment of the transfer, if any, required to the SAF which would be a cost to the State in the year in which the transfer was made and would presumably be met at the time from taxation income or borrowing.

Although the existence of the SAF would be an additional source of Government financing, we understand from NTMA that borrowing from the retail sector is not the most efficient way of raising finance and that they would not see any material benefit in the existence of an SAF from a debt management perspective.

It might be considered appropriate to set up an identifiable fund into which lump sums are invested and income paid out. This might give the SAF greater credibility in the eyes of the individuals who pay their lump sums into it rather than simply contributing to the Exchequer. However, we would not consider this to be an essential feature of the arrangement and suggest that this be a matter for Government to decide taking account of the broader picture. In particular, the amounts received may be too small to justify a separate fund at least in the initial stages of the SAF. We suggest that if there is no identifiable fund of assets to back the annuity promise, the name SAF be replaced by something else.

Would the SAF be considered to be an 'insurance undertaking'?

A key question would be how the SAF would be legally established. What legal form would it take?

It would seem key to the possible success of the SAF that it be structured in such a way as not to be classified as an 'insurance undertaking' in order that the SAF would not be required to maintain solvency margins or be constrained to invest the fund primarily in bonds to match its liabilities.

A key benefit put forward for the SAF idea is that by investing in a mix of equities, bonds and property it could obtain a superior return to that assumed in the pricing of annuities by insurance undertakings and provide the benefit of this additional return to annuitants through a higher annuity rate than would otherwise apply.

In order to be able to avoid being required to seek authorisation as an insurance undertaking, the SAF would have to fall under one of the Activities and Bodies Excluded in Article 3 of the Consolidated Life Directive¹.

A possible relevant exclusion would be 'insurance forming part of a statutory system of social security'².

¹ Directive 2002/83/EC

² Article 3(4), Directive 2002/83/EC

It is therefore questionable whether a SAF, if established as a fund or entity separate from the Social Insurance system, could in fact avoid having to seek authorisation as an insurance undertaking. Legal advice should be sought to clarify this point. If this is the case, it would be necessary to consider establishing the SAF within the Social Insurance system which might mean on a pay as you go basis.

Competition issues

If the State sets up in direct competition with insurers, there might be a complaint brought before the EU regarding unfair competition, although it might be the case (as suggested in the analysis of the annuity market later) that insurers would be happy to exit the market. Legal advice should be obtained on whether the proposal to establish an SAF might be open to challenge under EU Competition Law or otherwise.

Annuities offered

The nature of the annuity offered by the State Annuity Fund could vary by a number of factors:

- whether or not the annuity would be payable for life
- whether the annuity is to increase:
 - at a fixed rate, e.g. 3% pa.
 - in line with CPI, with or without a cap
 - in line with an earnings index, be it public sector or private sector
 - in line with Social Welfare Pension increases
- whether a level annuity option would be offered at all
- what survivor benefits might be offered and whether they would be optional or built in as standard
 - reversionary pension
 - a lump sum payment
- whether some form of long-term care benefit might be optional or built in as standard, e.g. an enhanced annuity in the event of the annuitant requiring long-term residential care
- whether terms offered would be 'unisex', i.e. identical for women and man of the same age
- whether the Fund would offer enhanced terms for 'impaired' lives, as some commercial annuity providers do.

If the Fund is to meet a number of different needs, e.g. purchase of annuities in relation to the involuntary wind up of funded defined benefit schemes, converting SPEARS AVC capital to public sector pension, purchase of annuity under a defined contribution scheme or PRSA, etc., then it may be required to design a number of different products, at different pricing terms, to meet these different needs.

The SAF would need to be able to provide annuities to match the pension entitlements of DB members on wind-up, and these could be calculated as required.

Under the State Option proposal we consider that only one type of annuity should be provided. This would be expected to be the 'gold standard' of annuity provision and hence might:

- not offer level annuities; at a minimum annuities would increase in line with CPI
- offer only unisex terms
- possibly offer better terms to impaired lives and those with life threatening disabilities (i.e. positive discrimination)
- offer built in survivor benefits as standard
- possibly offer some form of built in long-term care benefits as standard.

The result could be a very “high-spec” standard SAF annuity which, even with the benefit of the not for profit approach and potentially enhanced investment returns, could appear expensive to the certain occupational pension scheme members or PRSA holders compared to a conventional annuity or to the alternative of transferring retirement capital to an ARF.

Risks

As noted above, the State would be taking on financial risk and longevity risk. These risks would need to be carefully monitored and pricing adjusted as appropriate.

There are also significant political risks to State involvement in this area

- It is unlikely that the State will be able to remove the facility to invest in the SAF once it has been established (unlike commercial insurers who can close to new business if market conditions are unattractive)
- If State annuities are available only to certain segments of the population, there may be demand to make them available to all and for any level of lump sum investment
- If rates are reviewed to reflect market yields and changing mortality assumptions, there may be political concerns about worsening rates. Conversely, if rates improve (because of higher yields) those who purchased before the change may demand an increase in their annuities.

Administrative issues

We consider here the issues arising in relation to the State Option proposal as the process on winding up of an insolvent DB scheme will be somewhat different

The process in relation to the State Option involves

- Pricing the annuities
- Communicating the terms to the public
- Collecting the lump sum investments and processing these – either investing or paying into the appropriate Exchequer account
- Calculating the amounts due to the individual
- Making weekly or monthly payments to the individual
- Increasing the annuity as per the “contract” terms
- Providing spouse’s pensions on death of the annuitant

We presume that responsibility for pricing, investing (if appropriate) and accounting for the moneys would be a function of the Department of Finance and is likely to require some additional resourcing. It may be desirable to set up a separate function similar to or as part of the NTMA for this purpose.

Payment of the benefits and dealing with death claims could be handled by the Department of Social and Family Affairs in conjunction with payment of State pensions. Administrative difficulties could arise if the payment terms for the annuity were different to the main State pension e.g. different increase amounts and payment dates. It would seem desirable to bring these into line as much as possible.

Pricing the annuity

The annuity price will depend on the assumptions made regarding

- Expected rate of return
- Mortality

The proposals made in relation to the SAF suggest that the expected rate of return used for pricing could be a long-term yield on real investments rather than prevailing bond yields. The latter are used by insurers to price annuities and their annuity funds are largely invested in such assets. It is argued that the State does not need to invest the assets in bonds (indeed investing National Pensions Reserve Fund assets in Irish Government Stock is prohibited) as it does not need to satisfy insurance company regulatory and reserving requirements. Indeed the assets do not need to be invested at all but could be part of the central funds in which case use of a long-term real rate of return would seem logical.

The advantages of using a long-term rate are that this is likely to reduce prices relative to those charged by insurers and also it would not be expected to change frequently.

The mortality assumptions to adopt will also need some consideration. Whilst it may be considered reasonable to exclude some of the margins incorporated by insurance companies, it would seem prudent to reflect expected mortality improvements and the effect of selection. Again, it would seem desirable to adopt assumptions which do not need to be changed for a period.

The pricing process will require actuarial involvement, from either within the Department of Finance or external consultants.

Comment on Arguments against the SAF

The Report by the Board on the Review of the Funding Standard included arguments in favour of an SAF (paragraph 7.38) and arguments against (paragraph 7.39) which are reproduced in Appendix B. The subsequent IAPF discussion paper responds to the arguments made against the introduction of an SAF.

The points made are considered in turn below

1. Can the State provide cheaper annuities than commercial providers?

The IAPF analysis identifies 4 broad areas where additional costs incurred by insurers could be stripped out by a State provider:

Expenses/profit margins

Cost of capital

Mortality margins

Less restrictive investment policy

It is clear that some of the expenses (e.g. commission) and the profit margin will not arise under an SAF, although the level of expenses otherwise arising may still be comparable to or even higher than an established insurer. In any event, the overall saving made under this heading would not in itself justify setting up an SAF.

We understand that the cost of capital may be more significant than suggested in the IAPF analysis, possibly up to 5 or 6%. If this requirement does not arise for the SAF, it would clearly justify quite a significant reduction in annuity costs under the SAF.

IAPF suggest a significant saving would also arise in relation to margins in the mortality allowance, although it is difficult to establish what a best estimate would be. We do not think that significant savings should be anticipated from this item.

As noted by IAPF, the biggest “saving” would arise from the freedom to invest in assets other than bonds. If it is accepted that it is appropriate to reflect this in the SAF annuity pricing, a significant reduction in cost would arise. This would be particularly true in relation to index-linked annuities, where annuity pricing includes a margin to reflect the fact that there are no index linked gilts which track Irish CPI.

In summary, therefore, if the annuities are priced off a long-term yield on real assets rather than current market interest rates, significantly cheaper annuity rates could be offered by the SAF. If not, some margins can still be stripped out (expenses, cost of capital) which could give rates of the order of 10% to 15% cheaper than commercial insurers which might still be sufficiently attractive to justify the SAF.

2. The State would incur extra costs and require additional resources to deal with this new facility.

There would undoubtedly be some set-up costs, particularly if a new unit were established, but if the ongoing costs of paying pensions were included in the pricing (the IAPF suggest pension payment be undertaken by a third party payroll provider) the overall cost should be modest. Similarly, if the pensions under the State Pension Option proposal were paid as an addition to the Social welfare pension, costs should be contained.

3. There would be pressure to pay increases even if these were not part of the original Scheme entitlements, and to top up pensions if they fell short of Scheme entitlements due to lack of assets on wind up.

There would undoubtedly be such pressures but presumably the Department of Finance would have no problem with saying “no” if this was the basis on which the pension liabilities were taken on.

4. There would inevitably be “leakage” of the SAF facility to other DB members and to DC retirees.

Provided DB members get their full entitlements on wind-up, it should not matter to them whether they have a State annuity or an insured one and if their scheme is ongoing the issue does not arise. If the State Option proposal is accepted, DC members would get access to the SAF albeit up to a limit.

5. The annuity market would collapse

As noted in the Section on the annuity market, this probably would happen if the State competed in all areas of the market, and it was expected that it would do. However, the market should not collapse if access to the SAF is restricted to insolvent DB wind-ups and the State Option up to a modest limit.

6. The risks are understated

The intention underlying the SAF is that it should be cost-neutral in the long-term but clearly as the State is underwriting it, there will be a cost to the Exchequer if the assumptions used for pricing prove to be over-optimistic. However, this cost is only the difference between the expected and actual cost (and could even be a surplus), not the full cost of benefits which is the case with Social Welfare pensions and public sector pensions. In any event, if restricted to insolvent DB wind-ups, the total pension liability taken on by the State is likely to be modest. This of course would increase if the State pension option were introduced as well, but should still be modest relative to the other pension commitments of the State.

Implications for the Annuity Market

Introduction

If the State were to become an annuity provider, even in a limited way, this would have implications for the annuity market in Ireland.

The annuity market in Ireland

At present, 8 insurance companies write annuities in Ireland, but only about half of these have a significant market share. This has led to suggestions that the Irish market is uncompetitive but these can be countered by the fact that no overseas insurer has shown a willingness to enter the market, and we understand that in general the annuity writers do not make a significant (if any) margin on the business written. Total annuity premiums in 2004 amounted to about €230m, and has not grown in recent years, primarily due to the introduction of ARFs.

One other issue which should be highlighted is the cost of index linked annuities to match pensions under the rules of some schemes which are guaranteed inflationary increases (perhaps subject to a cap). These are not offered by the majority of insurers because there is no available matching asset i.e. Irish inflation linked gilts, and where they are available the cost is high relative to pensions with fixed increases due to the mismatch in liabilities and backing assets. The State could indirectly reduce pension costs for such schemes (and for individuals who wish to buy inflation protection in retirement) by issuing index linked stock, as suggested in a recent paper "Social and Economic Benefits of Irish Inflation-Linked Government Bonds" presented by Colm Fitzgerald FSAI to the Society of Actuaries in Ireland in February 2005. Although we understand that it is currently cheaper to raise finance by the issuance of conventional fixed interest stocks, this issue should be kept under consideration.

Buying annuities with insurers not established in the State

With the implementation of the 3rd Life Directive into law by the European Communities (Life Assurance) Framework Regulations of 1994, insurers established and authorised in another EU Member State and not established in this State nor operating in this State as a Branch became entitled to sell annuities to residents of the State on a cross border basis. This, in theory at least, should have increased the supply of annuity providers in the State. In particular one might have expected some large UK annuity providers to have come into the Irish market.

However this has not happened for a number of reasons:

- the currency mismatch between Sterling and first the Irish £ and then the euro has lessened the attractiveness of the Irish annuity market to UK insurers, who might have been expected to become annuity providers in the Irish market.
- The annuity market is very small by UK standards.
- Up until Finance Act 2005 only insurers who were *'lawfully carrying on in the State the business of granting annuities on human life'*³ could issue retirement annuities. This was taken to refer only to insurers established in the State or operating here through a Branch. This effectively precluded cross border insurers from issuing retirement annuities or annuities to retirement annuity holders. Finance Act 2005 now allows cross border EU authorised insurers to provide annuities to retirement annuity holders.
- uncertainty regarding the fiscal treatment of benefits received from an annuity issued by a cross border insurer.
 - It is uncertain whether such an annuity would fall to be classified as a *'foreign life policy'* under Section 730H(1), Taxes Consolidation Act, 1997, and if so what the resulting differing taxation consequences are for the trustees who may purchase the annuity and the annuitant who receives the annuity payments.

3 Section 784(2)(a)(i), Taxes Consolidation Act, 1997

- uncertainty over the regulatory and Revenue reporting requirements related to the investment in an annuity issued by a cross border insurer.
- If such a policy is deemed to be a '*foreign life policy*' then:
 - the trustees and/or individual receiving the annuity may be required under Section 730I, Taxes Consolidation Act, 1997 to make a return to Revenue, under the self assessment system, in the year in which the policy was acquired, setting out details of the annuity purchased.
 - the trustees and/or individual receiving the annuity may be required under Section 730J, Taxes Consolidation Act, 1997 to make a return to Revenue, under the self assessment system, each year setting out details of the income received in that year.

any intermediary involved in arranging such an annuity may also be required to annually return details of the annuity and the annuitant to the Revenue Commissioners under Section 896, Taxes Consolidation Act, 1997 as an 'offshore product'.

Possible consequences of SAF on annuity market

The impact of the SAF on the commercial annuity market will depend on a number of factors:

- the scope of the SAF, the products it offers and its pricing terms
- whether the SAF would be available, in certain circumstances, as an alternative option to commercial annuities or whether the SAF would replace commercial annuities in such circumstances, e.g. be compulsory in the involuntary wind up of funded defined benefit schemes.
- whether the ARF option would be available as an alternative option to the purchase of an annuity with the SAF.

In any circumstance in which the SAF option would co-exist side by side with the option of purchasing a *similar* annuity with a commercial annuity provider, then the superior terms, on a like for like basis, offered by the SAF would ensure that it would replace commercial annuity providers in this segment of the market.

Existing commercial annuity providers would not be able to compete on a like for like basis with the SAF, as the *raison d'être* of the SAF would be to offer *better* terms than commercial annuity providers could offer.

Intermediaries advising employers, trustees or members would be likely to always recommend the SAF for an annuity purchase over a commercial annuity provider where both options apply for a similar type of annuity purchase. IFSRA's Consumer Protection Code requires intermediaries to always act in the client's best interests.

Given the reported low level of profitability on existing annuity business, annuity providers might be very happy to withdraw from any segment of the annuity market where the SAF would be in direct competition with them for similar annuities.

Of course if the SAF option were to be confined to very specific and limited circumstances, such as the involuntary wind up of funded defined benefit schemes, then its impact on the commercial annuity market would be minimal.

However even in these limited circumstances it would introduce a distortion to the annuity market in that certain annuity purchasers with access to the SAF would be seen to be able to obtain far better terms for a similar type of annuity than other annuity purchasers who wouldn't have access to the SAF.

Commentators would inevitably seek to prepare and publish comparisons of the annuity rates as between the SAF and commercial providers. Of course it would be an unfair comparison. Nevertheless the SAF terms would make the existing annuity providers look bad value in relation to the commercial terms they could offer. This could make the annuity option appear even more unattractive than before, without necessarily any change in relative value for money offered by commercial annuity providers.

As a result there would be likely to be pressure to extend the enhanced SAF option to others, not just for involuntary scheme wind ups, to avoid the perceived 'rip off' terms of commercial annuity providers. e.g. members of defined contribution schemes not entitled to the ARF option.

It would in reality be difficult to contain a more favourable SAF annuity option to a small defined group or specified circumstances, such as the involuntary wind up of funded defined benefit schemes. If it were to spread to all potential purchasers of annuities it would eventually remove virtually all commercial annuity providers from the marketplace.

However the pressure to extend the SAF to all members of defined contribution schemes might be largely counteracted by making the ARF option available to all members of such schemes.

Even the SAF annuity terms would still look unattractive to many, compared with transferring retirement capital to an ARF.

Example:

Current commercial CPI linked annuity, 50% reversion to spouse, Male 60 : 3.0%

Equivalent SAF CPI linked annuity, 50% reversion to spouse, Male 60 : 3.75%⁴

Options to individual are therefore:

- €100,000 retirement capital transferred to an ARF, OR
- €3,000 pa pension from commercial annuity provider, OR
- €3,750 pa from SAF.

Most individuals would feel far 'richer' with €100,000 in an ARF compared to a right to a CPI linked pension of €3,750 pa, or just €300pm, before tax.

Given the current low absolute levels of annuity rates, a 25% say increase in current annuity rates would be unlikely to make annuity purchase attractive for many retirees compared with the alternative of preserving retirement capital in an ARF. The comparison with the SAF product could be even more unattractive if the Fund annuity product is "high-spec" e.g. CPI increases as standard, built in survivor benefits, etc.

Of course if the SAF annuity product is "high-spec" compared with conventional annuity options, there may be circumstances in which conventional annuities may appear to be more competitive (in terms of the initial annuity rate) than the State Annuity Fund product. e.g. a single life level annuity compared with a Fund CPI linked annuity with built in survivor and long-term care benefits.

Conclusions

We suggest that the introduction of the SAF would have the following consequences for the annuity market

- commercial annuity providers would probably withdraw from areas where the SAF competes directly with them for similar annuity types.
- if the SAF annuity product is "high spec", commercial annuity providers may be able to compete on terms of initial annuity rate for certain segments of the market.

4 assuming a 25% increase over commercial annuity rate.

- where the SAF annuity purchase is an option along side the ARF option, it is highly likely at current low absolute level of annuity rates that most retirees would opt for transfer to an ARF rather than using the same capital to buy an annuity with the SAF, even if the Fund annuity option is excellent value for money as an annuity.
- if it is desired to confine the SAF to certain selected sectors of the market, it may be necessary to extend the ARF option to all members of defined contribution schemes.
- if the SAF is to be provided as a social protection measure, then annuity purchase for the intended beneficiaries of the SAF would have to be compulsory if the benefit is to be taken up on a large scale by the intended beneficiaries of the social protection measure. This might be achieved by:
 - extending the ARF option to these individuals, but
 - modifying the current €63,500 AMRF/annuity requirement to a much higher level, e.g. at least €100,000, removing the AMRF alternative, and confining the annuity purchase of this amount to the SAF.

International Practice

Introduction

Our review of international practice identified some jurisdictions where the State provides a protection fund (USA, Germany, Ontario and the new PPF in the UK) but we are not aware of any existing arrangements similar to the proposed SAF.

We would be happy to carry out a more detailed review if required.

Of course, there are a number of EU countries where State pensions are at a higher level than Ireland, where there would probably be little if any demand for an SAF as a social protection measure.

Conclusions

Introduction

This purpose of this section is to summarise the key issues identified in the review and to give a view on the merits of the proposal.

Proposals for the SAF

There have been proposals to establish an SAF for two separate purposes:

- 1) To provide a mechanism where individuals with relatively modest accumulated retirement savings can obtain an income from the State in return for transferring their capital to it. This would be less expensive, more secure and less complex for the individual. This could be seen as a social protection measure, to offset the fact that the State pension is a relatively low percentage of National Average Earnings compared to some of our EU colleagues.
- 2) To enable DB schemes which go into involuntary, insolvent wind-up to discharge their pensioner liabilities more cheaply, thereby enabling higher benefits to be provided to them or to other scheme members. The existence of the SAF would permit DB schemes to fund by reference to an ongoing standard subject to a debt on the employer on wind up, and reduce the level of assets which schemes would be required to hold. It is claimed that the existence of the SAF would help to enable companies to continue with DB provision in circumstances where they would otherwise have ceased to do so.

As noted in the report, it might be the case that the types of annuity available from the SAF (and indeed the basis on which they are priced, issued and administered) differ in each of the above situations, and that it is more meaningful to think of two separate SAFs: a “retail” version for 1) and a “wholesale” version for 2).

Pricing the SAF

The IAPF have identified a number of areas in which commercial annuity providers include (or are required to include) margins which might not arise under the SAF. If the argument is accepted that pricing does not have to be linked to current gilt yields, but can be set by reference to some longer term real yield, there would clearly (in the current low interest/low inflation environment) be a significant saving, and other savings should be possible in relation to the profit margin, commission payments and cost of capital incurred by insurance companies. It is not clear that the expenses of operating the SAF will be lower than an insurance company, or that mortality assumptions should be significantly heavier (i.e. shorter expected longevity) than insurers, but overall the “savings” would enable annuities to be offered by the SAF on terms which were sufficiently cheaper than insurers to be worth the effort.

Clearly the key is the rate of return assumed, and if the assets taken in by the State are invested predominantly in real assets, or indeed used to finance State spending in other areas (which would otherwise require borrowing), there is a strong rationale for pricing annuities using a real rate of return. The State would be underwriting the risk that the assumed returns would not be achieved but this guarantee might not be too onerous over the long-term.

Investment of SAF

If the pricing advantage is to be achieved, the moneys received by the SAF must be invested in real assets. Alternatively, the SAF could operate on a Pay As You Go basis (which might be the more practical approach if the amounts paid in to it are small).

Would the SAF achieve the objectives claimed?

The availability of a State Option at retirement appears an attractive alternative to the options currently available. However, the impact of the SAF could be reduced if

- ARFs were more widely available, because people want to retain control over their capital or
- the SAF provided only index linked, joint life pensions, as those who wanted less “high-spec” offerings would probably purchase annuities in the commercial market.

However, if the terms offered by the SAF were relatively favourable, best advice for retirees with low levels of retirement provision (e.g. those whose only other income is the Social Welfare pension) who were risk averse would probably be to purchase an annuity from the SAF.

In the case of an actual insolvent wind-up, the extent to which members' benefits on wind up could be improved would depend on the funding level of the scheme, and the existence of the SAF facility might be misconstrued as a State guarantee e.g. like the UK PPF.

The key benefit of the SAF in the context of DB schemes is in conjunction with an ongoing funding standard, which could lead to a significant reduction in disclosed shortfalls and company contribution requirements. The extent of the reduction in contribution rates would depend on the exact terms of the SAF annuity basis, the funding level of the scheme and its maturity. The proposal would have little impact in the short to medium term on less mature schemes where pensioner liabilities are a small proportion of the total, or on schemes where annuities have traditionally been purchased at retirement. Indeed, the latter group might cease to purchase annuities if the SAF had the effect of reducing funding standard liabilities.

For larger, more mature schemes (some of which are closed to new entrants) the impact of valuing pensioner liabilities for funding standard purposes by reference to current market annuity rates has the effect of requiring contributions under a funding proposal significantly higher than the rates needed on the ongoing assumptions (even where these are prudent) to meet the benefits as they fall due. If the existence of the SAF enabled these ongoing assumptions to be used for funding standard calculations for such schemes, the likelihood that they would be continued rather than wound up would increase. Given the increasing number of mature DB schemes, this could have a significant impact on the number of employees covered by defined benefit schemes over the medium to long-term.

Potential problems

The main concern would be that any move by the State into this area would lead to calls for making the SAF available to all, and potential misunderstanding that it was in fact a pension protection fund which would guarantee (most of) members' benefits on a wind up. It would be important that the scope of the SAF was clearly prescribed at outset and explained clearly. However, this is unlikely to deter those wishing to lobby for greater State protection for pensioners.

Clearly, if the annuities were priced (either intentionally or otherwise) such that the Exchequer bore part of the cost of paying the pensions into the future, this could become a not insignificant additional cost in the longer term. This would need to be considered in the context of the State finances as a whole and is outside the scope of this report. It should however be remembered that the cost (if any) to be borne by the State would be the difference between the expected and actual payments made to individuals, and not the full amount of the pensions paid as is the case in Social Welfare and public sector pensions.

The administrative machinery which would need to be established, and the set up cost, have been suggested as issues to be taken into account, although it is not clear that these would be insurmountable. However, a detailed analysis of the requirements would be needed before this could be established.

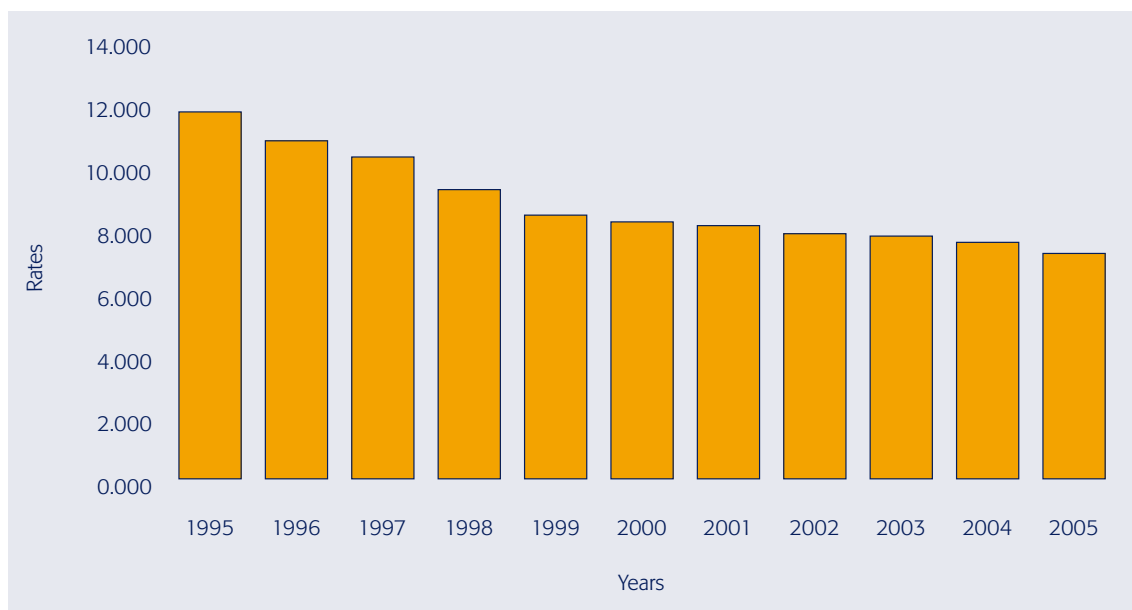
The future of the annuity market would also have to be considered. If State involvement was at such a level that commercial insurers were unable to compete for business, they would presumably withdraw from the market leaving the State as the sole provider. There could alternatively be a legal challenge in relation to unfair competition.

Scale of State involvement

Having considered the various aspects of the proposals, we are of the view that any State involvement in the annuity market should be quite limited i.e. in line with either or both of the proposals considered, but not extended to all pension arrangements. The types of annuity available to the limited "retail" market could also be restricted e.g. to an indexed, joint life annuity. This would limit the State's exposure and costs, minimise the impact on the annuity market and possibly avert any legal difficulties in relation to competition law or insurance regulation.

Appendix A – Illustrative annuity rates

Title: Annuity Rates Male Age 65



Appendix B - Extract from Pensions Board Report

State Annuity Fund

- 7.36 Because the Funding Standard for pensioner scheme members is based on the cost of commercially available annuities, the level of the Funding Standard for many schemes has increased as annuity costs have increased. This has led to consideration of alternative approaches to providing pensioner security. There was considerable interest in and discussion of the possibility of a State Annuity Fund, and the possible advantages and disadvantages, on an initial examination only, are set out below.
- 7.37 A State Annuity Fund would be intended to provide pensioner insurance at less cost than it is available from commercial insurers. In summary, such a fund would work as follows:
- (a) The fund would take responsibility for the payment of pensioners, including pension increases where appropriate. In exchange, the fund would receive a lump sum from the assets of the scheme;
 - (b) The fund would base its costs on assumed long-term rates of return and on mortality rates closer to those typically used in ongoing valuation calculations than to those underlying annuity rates. There would be allowance for administration costs but not for profit, solvency or risk margins; and
 - (c) Where a scheme was wound up with a shortfall, this fund would not make good any of the shortfall. The normal wind-up priority rules would apply, and the fund would provide pensions only in respect of the funds paid to it.
- 7.38 Arguments in favour of a State Annuity Fund include:
- (a) The benefits of such a fund would be that it would not incur the margins that commercial insurers include on their charges. The savings could potentially arise from a number of sources:
 - (i) Although the fund charges would include appropriate allowance for administration costs, there would be no margins for profit or solvency or other contingencies.
 - (ii) The mortality rates assumed by the fund might be less cautious than a commercial insurer, as the fund would only be seeking to break-even.
 - (b) Although such a fund would only be available to schemes that are wound up, the existence of the fund would allow the Funding Standard for pensioners to be lowered. The standard would be based not on the commercial insurance cost, but on the charge made by the fund in the event of a wind-up; and

- (c) It is noted that the State bears a considerable longevity risk in respect of Social Welfare and public service pensions, so that the real additional quantum of risk represented by an annuity fund as described would not be significant.

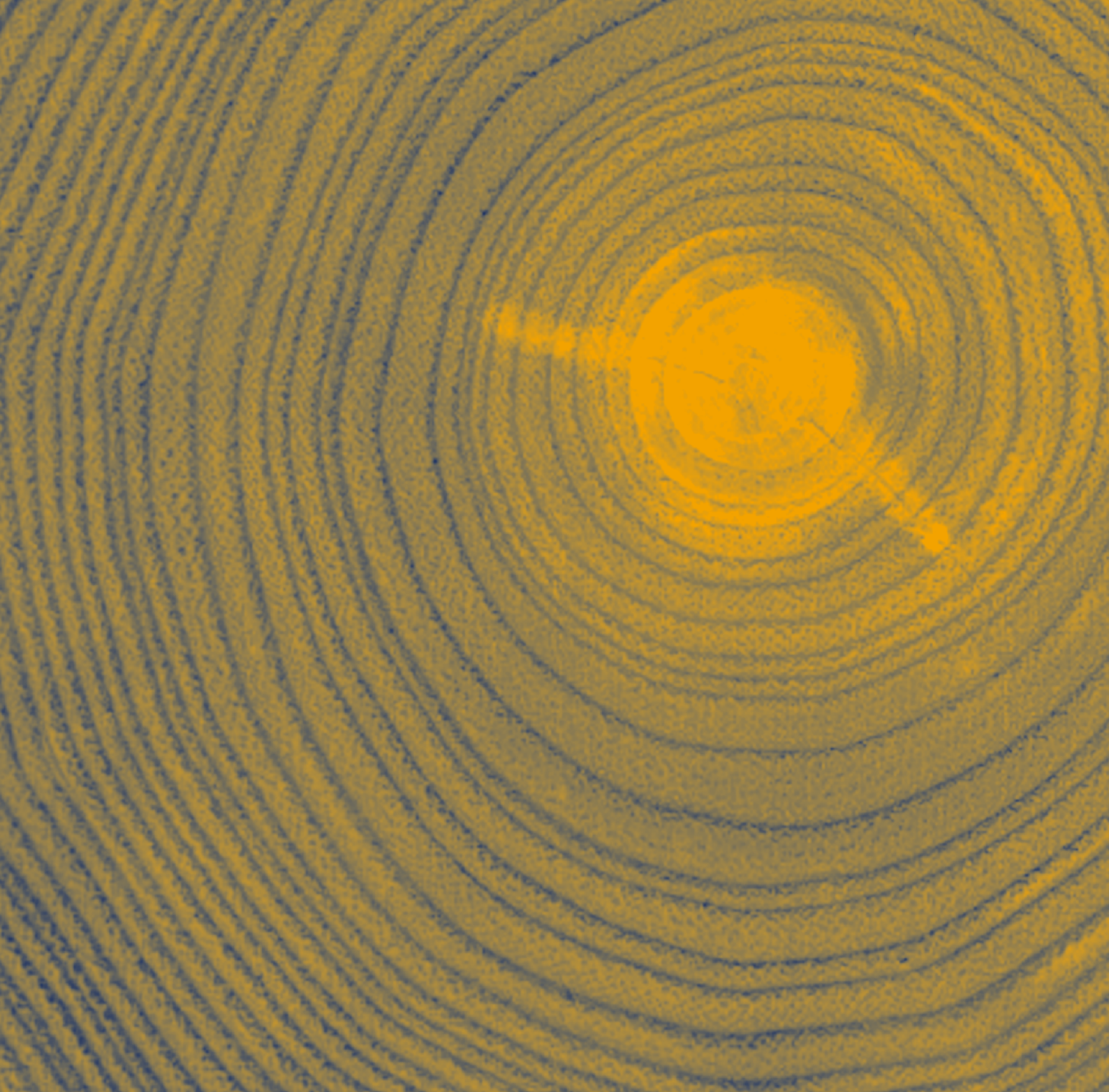
7.39 Arguments against a State Annuity Fund include:

- (a) In the absence of any detailed examination of the subject, it remains to be proven that pensioner insurance would be provided at less cost by the State Annuity Fund than by commercial insurers. Annuity prices reflect low interest rates and greater longevity and the State cannot hope to avoid the impact of such developments. In addition, if the State were to establish such a Fund, the Fund would have to take responsibility for the payment of pensioners out into the future and, inevitably, it would have to incur real extra costs in acquiring pensions-related expertise hitherto confined to the private sector;
- (b) Being operated under the auspices of the State, it would be unrealistic to assume that the Fund would not be subject to intense pressure to pay pension increases (even where they were not guaranteed under the original scheme) and to make good shortfalls in pension funds of companies involuntarily wound up. It would be exceedingly difficult for such pressure to be resisted;
- (c) It should not be assumed that the Fund could be confined to members of defined benefit schemes connected with involuntarily-wound up companies, especially if the members involved were found to be in a more favourable position than members of other DB schemes, let alone, of course, members of DC schemes and PRSA holders. Demands for parity of protection from the State against the vagaries of the pension marketplace (involving some form of State guarantee, perhaps) would be inevitable and, on grounds of equity, could well be difficult to resist, at potentially very substantial cost to the Exchequer. In addition, State involvement in the annuities business, through the Fund, could well be mirrored by a corresponding disengagement on the private sector's part over time, on the basis of the latter's perception that the State would play an ever-increasing part in the area. This would have substantive consequences for both the State and the pensions industry generally;
- (d) The contention that the real additional quantum of risk represented by an Annuity Fund would not be significant requires to be proven. Already, the cost to the State of a partial pre-funding of social welfare and public service pensions is extremely significant at 1% of GNP per annum, i.e. about 10% of social welfare expenditure at present. The cost to the State of an Annuity Fund, even on the scale envisaged by its proponents, let alone any extensions on the lines suggested in paragraph

7.38, could only be a tangible addition to the burden already borne by the Exchequer; and

- (e) There is concern that the expedient of establishing a State Annuity Fund is being proposed in the comparatively narrow context of devising a viable Funding Standard for defined benefit schemes. Insufficient regard is being paid to the possible consequences for the wider pensions area, for example, or the Exchequer, which through very sizeable tax foregone on an annual basis (estimated to be of the order of at least €2.5 billion at present), already provides a very significant degree of support for the sector. All the implications of the initiative would need to be explored fully before a proposal for action were submitted for approval to relevant Departments, the Government and the Oireachtas.

7.40 The Board recommends that the implications of the establishment of a State Annuity Fund should be considered thoroughly taking account, inter alia, of the advantages and disadvantages set out above. Such an examination would enable the Board to consider the proposition further in the medium term.



APPENDIX 8

INDECON REVIEW OF POTENTIAL OPTIONS TO ENCOURAGE INCREASED PENSION COVERAGE

MARCH 2005

APPENDIX 8 – INDECON REVIEW OF POTENTIAL OPTIONS TO ENCOURAGE INCREASED PENSION COVERAGE

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Indecon International Economic Consultants

Commissioned by The Pensions Board in 2004 and being considered in the context of the
National Pensions Review 2005

March 2005

Executive Summary

This report presents an independent review of potential cost-effective policy options to improve pension coverage in Ireland which could be introduced within a short time horizon. It was prepared by Indecon International Economic Consultants for the Pension Board.

Our analysis is based on a rigorous review of the factors which are hindering pension coverage. Some factors such as affordability may not be amenable to fiscal incentives. We believe, however, that there is a case for targeted additional incentives. It is however essential that any new incentives take account of the need to address equality, efficiency and deadweight concerns.

Our research indicates that (for the first quarter of 2004) 52.4% of persons in employment aged between 20-69 have a pension. This is a marginal increase on 2002, but markedly below the targets for pension coverage set by the Pensions Board. Market research data suggest that those less likely to save and make a pensions provision are younger and from a lower socio-economic class. There has recently been an increase in take-up of PRSA pensions but average employee contributions are modest.

Our analysis shows that there is considerable variation in private pension fund contributions across households with different levels of disposable income. In particular, private pension fund contributions are increasing with income. There will of course also be variation in spending within, as well as across, income deciles.

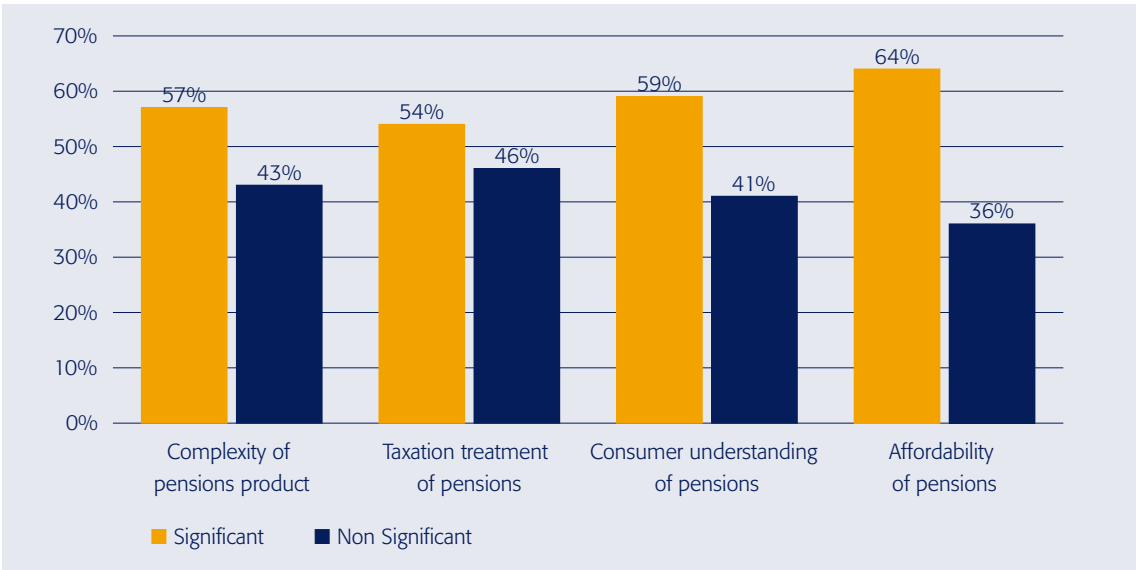
On the issue of SSIA savings these have well exceeded expectations with over 1.1 million account holders. The Exchequer costs to-date have been significant and are estimated at €1.5 billion. Annual subscriptions to SSIA average €165 per month similar to the average PRSA contribution. Percent responses suggest that holders are increasing their current contributions. 40% of SSIA account holders are saving the maximum amount. Research suggests that 38% of SSIA account holders indicated that they would save all or part of their SSIA savings, but only 9% suggested an intention to invest all or some in a pension plan or to use for retirement.

Survey data has been specially commissioned by Indecon for this study that focuses on the barriers to increasing pension coverage in Ireland, as well as the likely impact of a number of pension-related initiatives. Respondents were asked a number of questions in relation to: ownership of selected financial products including pension products and SSIA's; potential barriers to increasing pensions coverage; the likely impact of enhanced tax allowances; and the impact of allowing transfers of SSIA monies into pensions.

Overall, 45% of respondents indicated they had an occupational pension, PRSA or other pension product which is broadly similar to the results of CSO research, while it is estimated that 41% have SSIA's. The survey evidence suggests that much higher proportions of older respondents own these products compared to younger respondents.

In relation to the main potential barriers to increasing pension coverage in Ireland, the barrier identified by the highest proportion of survey respondents as a significant barrier was "affordability of pensions" - 64%. High proportions of respondents also identified "consumer understanding of pensions" and "complexity of pensions products" as significant (59% and 57% respectively). Taxation incentives were also seen as important as is evident from the chart on the potential barriers to increasing pension provision.

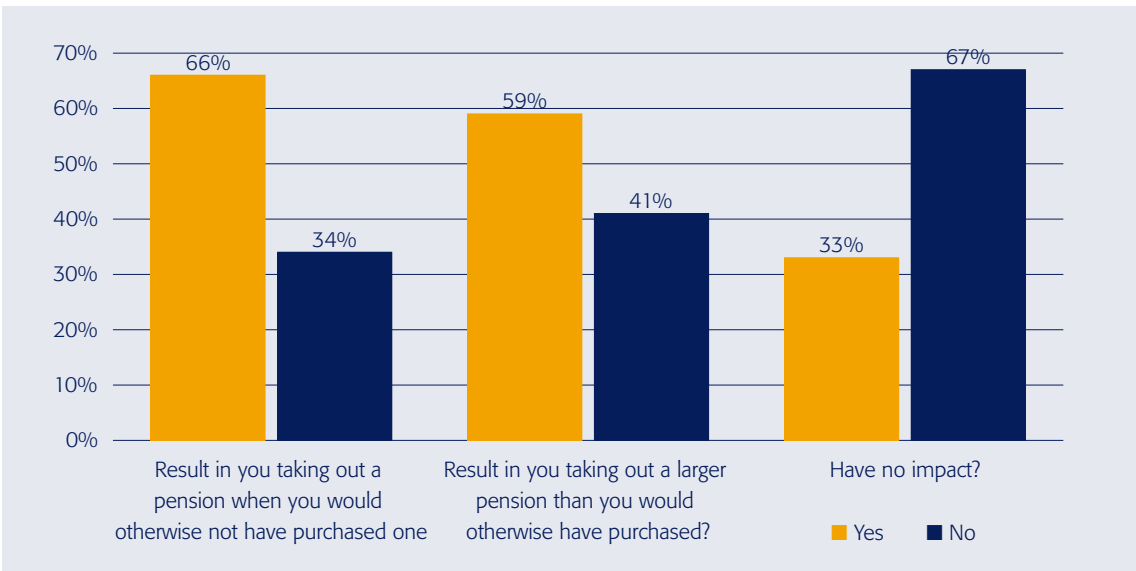
Main Potential Barriers to Increasing Pensions Coverage



Source: Indecon commissioned TNS mrbi survey.

One of the important issues examined in this study is the likely impact of enhanced fiscal incentives on the coverage of pension provisions. The survey evidence suggests that 66% of respondents would be more likely take out a pension if the Government introduced additional tax allowances on pension contributions. 59% indicated that the improved tax allowances would result in them taking out a larger pension, while only 33% indicated that this type of policy intervention would have no impact.

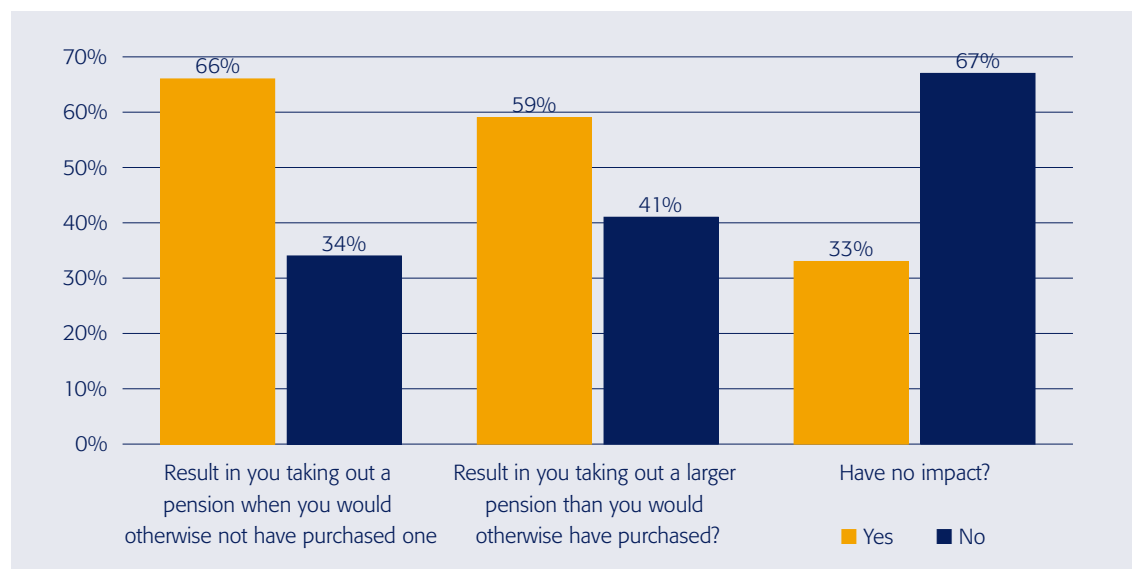
Likely Impact of Enhanced Tax Allowances



Source: Indecon commissioned TNS mrbi survey.

In relation to the impact of any new tax relief on SSIA funds transferred to pensions, 54% of respondents suggested they would be more likely take out a pension, while 40% indicated that this tax relief would result in them taking out a larger pension. 34% indicated that this option would have no impact.

Impact of Allowing Transfers of SSIA Monies Into Pensions



Source: Indecon commissioned TNS mrbi survey.

Key Policy Considerations

Our analysis shows that a large percentage of the population have no or very limited pensions coverage although some progress has been made since the Report of the National Pensions Policy Initiative¹ in extending pensions coverage. However, coverage is well below the interim targets recommended in the NPPI Report and accepted by Government.

Accordingly, the background to this policy discussion is an assumption that there is inadequate coverage and that there is a significant gap between current coverage levels and the interim targets recommended in the NPPI Report.

In addition, it needs to be stressed that Government pension's policy has been evolving. In recent years the basic State Pension has been increased in excess of growth in earnings and the Government is committed to achieving the target of having the State Pension equal to 34% of the average manufacturing wage as recommended by the NPPI. PRSAs have been introduced as a new pensions product supported by Government initiatives. Also of significance is the fact that the Exchequer provides tax relief at a taxpayers' marginal tax rate for contributions into private pensions schemes. For standard rate taxpayers, relief is available at 20% while relief is available at 42% for higher rate taxpayers.

In May 2001 the Government introduced an additional savings scheme (SSIA) that provided an Exchequer funded top-up payment of €1 for every €4 saved. This, not surprisingly, attracted significant funds and has encouraged savings including amongst sections of the population where pensions coverage may be inadequate.

The total Exchequer cost of supports for private savings and pensions indicate that very significant government incentives are provided for the pension sector. It should be stressed that this is in part deferred tax payments, as pension income is taxable. Our analysis shows that over 670,000 employees secured tax relief on pensions and a further 109,000 benefit from tax relief on retirement annuity pensions. For comparison, it is interesting to note that the numbers employed in the economy, on a seasonally adjusted basis were 1,865,000 in Jun-Aug 2004.

¹ Securing Retirement Income, National Pensions Policy Initiative Report of the Pensions Board.

Discussion of Various Options

In our report we discuss the various options for encouraging a greater take-up of pensions. The main options which have been suggested to Indecon are outlined in the table below as well as a number of additional options which have been developed by the consultancy team. Each of these are discussed below.

Option for Fiscal and Other Financial Supports Considered by Indecon	
(1)	Continue with the Status Quo
(2)	Increase in pension contribution limits
(3)	Exempt 23% exit tax on capital gains on SSIA accounts
(4)	Pension related tax credit
(5)	Family income support tax credit uplift for pension contributions
(6)	Tax incentive for child pension accounts
(7)	Employers' PRSI savings due to employee contributions to be transferred in employees' pension fund
(8)	Further Support for PRSAs
(9)	Detailed review of regulatory framework for PRSAs
(10)	Industry action to increase consumer understanding and improved marketing
(11)	Incentives for Employers

Continue with the Status Quo

The first policy option which Indecon believes must be the benchmark for any other option is to continue with the status quo. This has the advantage that it would not involve additional Exchequer costs. In addition, it would not add further uncertainty into the market given the rapid change in recent years.

The disadvantage of the current position is that it would not take account of the benefits of measures which would direct part of SSIA monies into pensions and thereby reduce the inflationary impact on the economy. Also the status quo would not address the need to increase the level of pension take-up.

Increase in Pension Contributions Limits

A number of proposals have been made to increase pension contribution limits. These have ranged from very generalised proposed incentives to increases in pension contribution levels for SSIA accounts. In our review we focused on two specific proposals, namely an increase in pension contribution levels for SSIA accounts and a more targeted incentive to increase pension contributions on a once-off basis for individuals who had underutilised contributions.

The SSIA accounts will mature over the period May 2006 to May 2007. Several proposals have been suggested to encourage the transfer of some of this SSIA money into pensions. These include the proposal to have a once-off increase in pension contributions limits for all SSIA account holders. Market research suggests that in the absence of new initiatives only a very small percentage of these funds will be directed to pensions.

Under existing policy, individuals can make pension contributions up to a certain percentage of their income and avail of the tax relief at either the standard or marginal rate depending on the individual's tax position. It has been suggested to Indecon that these limits should be increased for all SSIA account holders on a once-off basis to encourage the transfer of SSIA funds into pension accounts. This would benefit individuals who have sufficient SSIA funds which are in excess of their current allowable limit for pension contributions.

It has been suggested to Indecon that the benefits of this proposal include the following:

- It would minimise the negative macroeconomic effects of SSIA funds flowing into inflationary expenditures;
- It could encourage an increase in pensions take-up;
- It could encourage existing pension holders to increase their contributions.

Indecon accepts that the benefits are valid but believe that despite these benefits there are a number of downsides to this proposal as follows:

- This is not targeted at those who do not at present have a pension or have inadequate pension provisions;
- There are no benefits from this proposal to those without a tax liability and it provides only a modest benefit to those on low incomes;
- SSIA account holders have already secured very substantial Exchequer subsidies and an increase in the current limits for all SSIA account holders could provide additional benefits regardless of whether the individuals currently had adequate pension provision.

We believe however that a modified version of the proposal on pension limits discussed above and targeted at selected groups would merit consideration. In particular we believe there would be merit in refining the proposed increase in pensions contributions limits to allow for the transfer of SSIA monies for individuals who have not used their total allowable contribution in recent years. For example, an individual earning €50,000 and aged 30-39 could have made a maximum contribution of €10,000 in each of the previous three years. Let's assume that a person has been contributing €7,500 each year; this equates to an unused contribution of €7,500 over the three-year period. One option is to permit individuals to add this amount to the individual's contribution limit in either of the two years in which the SSIA will be encashed.

This proposal would particularly focus resources on those persons without any pension or who have underinvested in pension provision in recent years. This minimises deadweight effects, in as much as persons making the maximum contribution would not benefit, and it would tend to focus resources on those individuals not making adequate contributions at present.

We believe also that the once-off timetable could be effectively used by the pension industry in their marketing effects to encourage pension take-up and could also assist in minimising the inflationary impact of SSIA related expenditures. We propose that this once-off use of underutilised allowances should be linked with the years of the ending of SSIA but should be available to individuals regardless of whether they hold an SSIA account or not. This would therefore not restrict this additional incentive only to those who were in a position to afford SSIA investments.

Exemption of Exit Tax on Capital Gains on SSIA Accounts on Transfer to a Pension

A proposal suggested to Indecon relates to the exemption of the 23% exit tax on the total gains of all SSIA accounts on maturity. For convenience, we assume that the capital gain on the funds invested equals €2 billion. At a tax rate of 23%, this equates to a tax liability of €460 million. A proposal from the Irish Insurance Federation, in their 2005 pre-budget submission, suggests that this tax should be waived if the monies are transferred into a pension fund. If we assume that even 50% of the capital gain is transferred, the cost to the Exchequer is €230 million.

The arguments for and against this proposal are similar to the points raised earlier in relation of the increase in the contribution limit. There are a number of potential benefits for this initiative, but issues may arise in relation to equity, targeting and deadweight.

We believe however that a modified version of this proposal has significant merits. Specifically we believe there is a strong case to exempt the exit tax for individuals who invest the capital gains in pensions provided the exempt amount does not also result in an additional income tax relief on these specific pension fund contributions. This could be exempt at source providing an ease of administration for pension contributions.

For those employees who are not in the tax net this additional incentive would be a significant benefit and would also be of some limited benefit to those who are paying tax at the standard rate. This provision would also assist the sector in their marketing to secure wider pension coverage by highlighting to SSIA investors the potential ability to secure an exemption from the SSIA capital gain exit tax.

We would also be supportive of an exemption from any SSIA penalties for early withdrawal of SSIA funds provided these are invested in pensions and this provision should be available to owners of SMEs who have SSIA accounts who invest in employee pension funds as well as to individuals.

Pension Related Tax Credit

The proposed exemption of SSIA capital gains exit tax for selected pensioners is a specific example of a credit or payment by the state to certain individuals who invest in pensions. This is of particular value to those who are not in the tax net. In this context it is useful to consider the wider issue of the introduction of tax credits to increase pensions coverage. Data on the distribution of income earners by tax category is presented below.

Distribution of Income Earners on the Income Tax File for 2005					
	Exempt	Marginal Relief	Standard Rate	Higher Rate	Total
On a Pre-Budget Basis	590,457	13,735	620,239	685,848	1,910,279
Percentage of Taxpayers	30.9%	0.7%	32.5%	35.9%	
On a Post-Budget Basis	656,517	11,947	608,075	633,740	1,910,279
Percentage of Taxpayers	34.4%	0.6%	31.8%	33.2%	

Source: Department of Finance

The pre-Budget distribution forecasts the numbers of income earners, (assuming income growth for 2005), which would be in each tax band in 2005 if no Budget were introduced.

A jointly assessed married couple is treated as one tax case.

For some individuals with no or very low tax liability, the introduction of tax credits could encourage pensions take-up. There are various ways that pension tax credit could operate. It has been suggested that the tax credit could be organised as a transfer with a pensions provider as is already the case with SSIAs as we believe this has distinct merits.

There are a number of different ways in which this could operate, including one or both of the following:

- For the Government to transfer a credit of a fixed sum to the pension provider;
- And/or for individuals to claim a tax credit equivalent to a percentage of the amount invested in a pension.

A tax credit for pensions would ensure the integration with the existing system and allow a taxpayer to claim the tax credit or relief under the existing, whichever option is in their financial interest.

We believe that there are very strong arguments in favour of introducing a system of tax credits for pensions as it would provide significant benefits to individuals who do not benefit under the existing tax relief arrangements.

It is proposed that the pension tax credit would be available to those not currently claiming income tax relief on pensions. This would represent an effective targeted measure with significant equity advantages. It would also focus the incentive on those groups which are less likely to have adequate pension provision. If such a pension

tax credit was provided in the form of 20% of pension contribution it would benefit those employees who have incomes below the taxable levels. However if this was given direct to pension providers as a matching contribution it may also increase the understanding and attractiveness of pension incentives to those on medium incomes.

Family Income Support Tax Credit Uplift for Pension Contributions

A more limited version of this tax credit scheme would be to provide pension tax credits through modifications of the family income supplement system. This could be provided as an uplift on the FIS amount, for contributions to private pensions. The advantage of this would be that it would provide an incentive for pension take up for low income working families and there is an existing administrative mechanism by which this could be undertaken. It could also be introduced quickly at low exchequer costs. In the current calculation of the FIS payment we understand that relief is given for pension contributions which are a deduction from gross earnings. We would, however, favour a more widespread introduction of a tax credit system as FIS would not provide any incentive to single individuals or those falling outside the FIS criteria, but this would be a potentially welcome first step.

Tax Incentive for Child Pension Accounts

There are various proposals to establish special pension accounts for children in order to encourage the savings and pensions habit. There are a number of specific proposals suggested to Indecon that we discuss briefly in this section.

SIPTU has for some time been proposing the establishment of special pensions accounts for all children. Prior to Budget 2005 they put forward a detailed proposal suggesting that the basic rate of Child Benefit be increased to €150 per month (a target already set under national agreements) and that an extra 10%, (which would be €15 per month), should then be added and earmarked for pensions. This 'from birth' arrangement would apply to all children born after January 1, 2005. For children born prior to that date, they suggested that the Child Pension Accounts (CPAs) could be set up at the point when the child comes off Child Benefit (i.e. usually at age 17 or 18). This could be done by paying a lump sum, or "pensions start-up bonus" – equivalent to, say, six months Child Benefit – which would be used to set up their special pension account. SIPTU have suggested that this particular mechanism would spread the cost to the Exchequer over 17-18 years (as only 2 age cohorts would be covered each year, i.e. 0-1 and 17-18) and would mean that after that period virtually every young person below the age of 36 would have a personal pension account. This account could be added to, or used to supplement, pensions provided through social insurance, occupational pensions or other supplementary arrangements.

SIPTU also proposed that tax relief would be available for additional contributions to these child pension accounts (e.g. from parents, grandparents, etc.) with appropriate ceilings on any contributions for which tax relief could be claimed. SIPTU also believes that while the purpose of these CPAs would have to be the provision of a mechanism for ensuring very long-term savings, primarily for pension purposes, some early encashment of these funds would be desirable (e.g. a once-off chance to take 25% of the fund at around age 25 probably for housing purposes) and this would also add to their attractiveness.

Indecon would be supportive of considering utilising part of any future uplift in Child Benefit for this purpose.

The Irish Insurance Federation (IIF) have proposed a scheme with the establishment of a personal pension for every child in the State. The main elements, which are drawn directly from the IIF statement, are as follows:

- A personal pension account should be opened for every child in the country and the Government should deposit €10 a month into each child's account until he/she turns eighteen. (Cost: €130 million per annum);
- A Sponsor(s) (e.g. a parent or guardian of the child) may make additional contributions to the child's account of between €5-€50 per month over the same time period;
- For every €5 contributed by sponsors it is proposed that the government would contribute an additional €1;

On the account-holder's 25th birthday he/she may withdraw 25% of the current gross value of the fund tax-free *if and only if* he/she has been contributing a minimum of 5% of earnings when working. The remainder cannot be accessed until retirement.

IIF suggests the potential costs to the Exchequer of their proposal would be of the order of €180 million per annum.

The IIF submission has suggested that the benefits of this proposal are that:

- Every child in the country now has a growing pension fund from birth;
- The 18-25 rule would develop in the child/young adult a positive attitude to saving and a saving habit;
- The necessity for the State to put increasing funds aside to look after senior citizens will be reduced;
- This would lead to better-funded personal pensions.

Indecon believe that there are a number of issues regarding the child pension incentives including whether they would provide incentives to high income families (including to economic consultants!) who do not need the state assistance. Also of concern is whether such initiatives would result in genuine pension habits or simply represent a form of short-term savings which would be spent subsequently. There is also the issue of equity in terms of the treatment of spouses versus children. If this incentive was capped to a maximum of existing contribution levels the issue of discrimination between children of public servants and other groups in the labour market could arise.

If it is decided despite the issues raised above to introduce an incentive for children's pensions we believe this should either be in the form of a tax credit or alternatively any new allowance should only be available at the standard rate of tax. Any relief on children's pensions could be subject to the adults current contribution limit, so that an individual currently securing maximum personal tax relief on pensions up to the current limits would not be eligible to secure additional relief for their children.

Employers PRSI Savings to be Transferred to Employee Pension Funds

In our discussions with social partners and others on extending coverage, the question of mandatory provision was raised. In a number of the confidential submissions received from pension industry sources this was recommended but we understand there is widespread employer resistance to this. This approach has been adopted in a number of other countries but requires careful evaluation.

One specific aspect of this is whether it should be required for employers to transfer any PRSI savings when making deductions for employee contribution. This latter issue was examined by Coyle Hamilton in a recent study. We understand that the current position of the Policy Committee of the Pensions Board is that after much discussion it was felt that applying the employers' PRSI savings to employees had administrative cost implications and it was felt this was not consistent with pensions simplification. Indecon believe that employers should be encouraged to contribute any PRSI savings and there is merit in considering more widespread employer incentives.

Detailed Review of Regulatory Framework for PRSAs

In terms of the regulation of pensions, and in particular PRSAs, there are concerns from pension industry sources about the limited impact of PRSAs on the market. A number of providers had stated that PRSAs had replaced personal pensions for many self-employed persons. For persons in non-pensionable employment it has been suggested that the impact so far has been limited.

A feature, which may have implications for coverage, is that we have been informed that brokers may be selling less than 20 % of PRSAs. Brokers are significant players in the overall pensions market and if these estimates are correct it may have implications on take-up of PRSAs.

It is argued by some in the industry that the sale of a PRSA is unnecessarily complex and the actual sales process is time-consuming and expensive. This may be partly due to the procedure that needs to be followed and we have been informed that an estimated 14 documents need to be completed to finalise a PRSA sell. These requirements are governed by different regulators.

A further complicating factor is there are a number of regulators involved including, the Pensions Board and the Revenue Commissioners. There are also concerns in the sector about the time taken to approve new products. It has been suggested to us that this approval and sales processes is unnecessarily slow, but a detailed investigation of whether this is the case or not is outside the scope of this assignment. It is, however, essential that there is adequate consumer protection and consumer research does not place as much attention on regulation compared to other barriers to pension take-up.

A detailed evaluation of the regulatory context for PRSAs and other pension products is outside the scope of this study but we would recommend that the Pension Board in association with other interests undertake a detailed review of regulation to ensure that there is sufficient consumer protection and that regulatory requirements are consistent with encouraging pension take-up.

Industry Action to Increase Consumer Understanding and Improved Marketing

An important barrier to take up of pensions is consumers assessment of the complexity of pension products and the difficulties in understanding the nature of the product offering.

This has important implications for the sector and enhanced industry action is needed to increase consumer understanding, simplify products and improve the marketing of pensions. Recent improvements in the performance of pension funds reflecting the improvements in equity markets should also assist in pension take-up. Indecon however accepts that there are constraints on the pension industry arising from the regulatory environment.

Incentives For Employers Investment In Pensions

We believe that ways to incentivise employers to invest in pensions should be an important element of any medium term plan to enhance pension coverage. This could include ways to ease administrative and financial costs particularly on SMEs. Within this restricted assignment it has not been feasible for Indecon to develop cost-effective targeted proposals on this area but we support a more detailed review of this issue.

Recommendations

Based on the detailed analysis undertaken by the consultancy team and taking account of our assessment of the barriers to pensions take-up we have recommended a number of new initiatives as outlined in the table below. The recommendations also reflect the need to ensure that any new incentives are equitable and cost-effective.

Proposed Recommendations
1. Once-off increase in pension contribution limits for individuals with underutilised contributions over past three years
2. Exempt 23% exit tax on capital gains on SSIA accounts upon transfer to pension fund providing no income tax relief is obtained on this amount
3. Pensions related tax credit providing no income tax relief is obtained
4. Family income support tax credit uplift for pension contributions
5. Detailed review of regulatory framework for PRSAs
6. Industry action to increase consumer understanding and improved marketing
7. Review of Incentives for SME involvement in Pensions

Source: Indecon

We believe these recommendations would assist in increasing pension take-up and would address equity, effectiveness and deadweight concerns. The proposed additional incentives represent a package of new targeted initiatives which are focused on those groups with no or inadequate pension provisions. They would also assist the sector in marketing pension options to SSIA account holders and therefore reduce the inflationary impact of SSIA fund expenditures.

1 Introduction and Terms of Reference

1.1 Introduction

This report presents an independent review of potential cost-effective policy options to improve pensions coverage in Ireland. It was prepared by Indecon International Economic Consultants for the Pensions Board.

1.2 Terms of Reference

The Terms of Reference for this study are to:

1. Collate research carried out by various sources to date;
2. Contain policy argumentation (at both pensions and fiscal/economic levels); and,
3. Put forward concrete proposals for consideration.
 - Proposals that could be considered in the context of national decision-making, with a view to increasing pension coverage.
 - Proposals should be consistent with the objective of simplifying the regulatory and tax environment for pensions and whose benefits are readily identifiable to the general public;

1.3 Acknowledgements

The consultancy team would like to acknowledge the invaluable assistance given to the team by officials of the Pensions Board including Ian Woods, Anne Maher, Philip Dalton and Brendan Kennedy and other senior colleagues as well as members of the Pensions Board Policy Committee. We would also like to particularly thank the extensive inputs and information provided to the consultancy team by leading pension providers in the sector. We would also like to thank key public officials as well as representatives of the pensions industry for valuable inputs as well as inputs received from Niall Doyle, IIF, Rosheen Callender, SIPTU and Michael O'Halloran, Irish Senior Citizens Parliament and from IFSRA and the Irish Brokers Association. Thanks are also due to the Department of Finance for providing information to the consultants. Due to the tight timescale for completing this study it is not feasible to consult with all representative organisations and with all regulators or to undertake new survey work with brokers. This could be considered subsequently by the Pensions Board in its own consultation on the reports recommendations. The usual disclaimer applies however, and the independent views and analysis in this report are the sole responsibility of Indecon.

As part of this study, despite the very tight timescale for completion, we completed a consultation programme which involved inviting submission from leading pension providers and from a selected number of the Social Partners. Indecon would like to thank these organisations who provided detailed submissions to the team.

1.4 Structure of the Report

The structure of this report is as follows: Section two presents data on trends in savings and pensions coverage. Section three examines trends in SSIA savings, given the importance of this incentive in attracting savings and the suggestions by the industry for proposals that seek to retain some of the elements of this scheme for pensions and savings incentives. Section four examines evidence on pensions from the Household Budget Survey. Section five presents new evidence from a sample of population commenced by Indecon specifically for this study. In the following section the report examines the research on the links between extending pension coverage and incentives. In section seven a review is undertaken of a range of policy options and in this section we set out our main recommendations.

2 Savings and Pensions Coverage

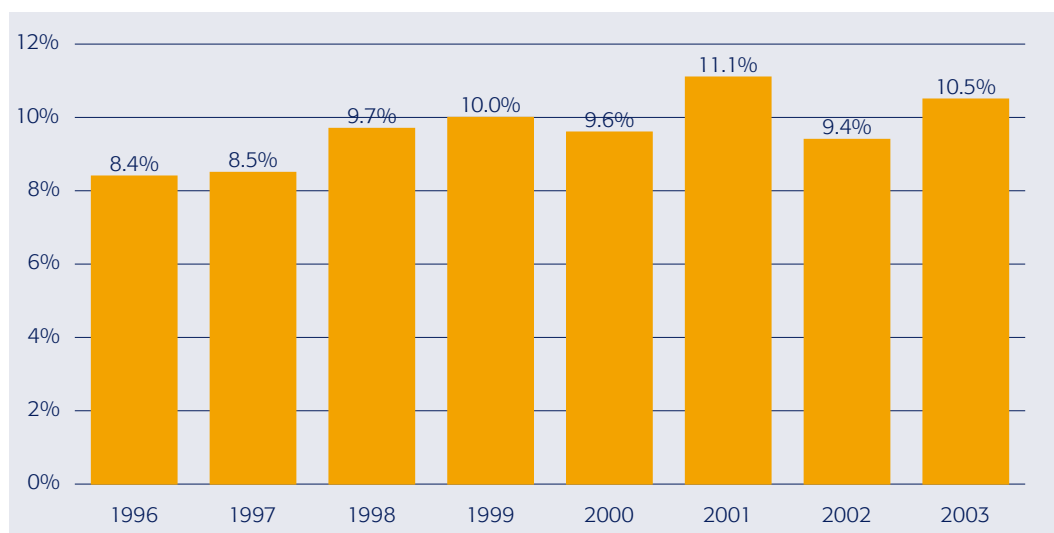
2.1 Introduction

In this chapter we examine the latest data on pensions and savings. Data from the CSO, government agencies and private market research companies are the main sources for this section. We would like to thank the industry and the Pensions Board and official statistical sources for facilitating access by Indecon to the available research.

2.2 Savings

The best measure of savings in the Irish economy is provided by national accounts measures published by the CSO. Data for the ratio of savings to disposable income (income less taxes) is shown in Figure 2.1. The data are given for the years from 1996 to 2003 and indicate little change over the period. In 2003 the ratio of savings to disposable income was 10.5%, an increase from the previous year (9.4%) but down from 11.1% in 2001.

Figure 2.1: Savings Ratio as a Percentage of Disposable Income



Source: Indecon analysis of CSO and ESRI data for 2003.

2.3 Pensions Coverage

Of particular relevance for this study are data on pensions coverage. Table 2.1 and Table 2.2 provide a breakdown of the type of pension coverage held by employed persons for the first quarter, 2002 and 2004. There was little overall change in the figures for pension coverage between the two years, however, there was a noticeable increase in the number of persons having both occupational and personal pension plans.

Table 2.1: Pension Coverage in the State for Persons in Employment Aged 20 to 69 years, Q1 2004 (%) – State

	Occupational Pension only	Personal Pension only	Both	Total Coverage	No Pension ²	Total
State	33.1	13.0	6.3	52.4	47.6	100

Source: CSO.

2 Includes those answering "No", "Don't know" or "Not Applicable".

Overall 52.4% of respondents had a pension in 2004 compared with 51.2% in 2002. This suggests a marginal increase in total pension coverage. However, this does not take account of trends in PRSAs during 2004. The figures suggest that pension coverage has increased but is well below the targets recommended by NPPI and accepted by Government.

Table 2.2: Pension Coverage in the State for Persons in Employment Aged 20 to 69 years, Q1 2002 (%) – State

	Occupational Pension only	Personal Pension only	Both	Total Coverage	No Pension	Total
State	35.4	12.9	2.9	51.2	48.8	100

Source: CSO.

A regional breakdown of the type of pension coverage held by employed persons is given in Table 2.3. As one might expect, the greater Dublin area (55.7%) and the Mid-East (58.0%) show a higher than national average (52.4%) pension cover. The areas with the lowest pension coverage for employed persons were the Midlands (44.7%), the West (45.6%) and the Border area (47.9%). In these three areas, more than half of those employed aged 20 to 69 years have no pension coverage.

Table 2.3: Pension Coverage in the State for Persons in Employment Aged 20 to 69 years, Q1 2004 (%) – By Region

	Occupational Pension only	Personal Pension only	Both	Total Coverage	No Pension	Total
Border	31.0	12.4	4.5	47.9	52.1	100
Midlands	29.9	11.0	3.8	44.7	55.3	100
West	26.4	13.1	6.1	45.6	54.4	100
Dublin	38.1	10.1	7.6	55.7	44.3	100
Mid-East	31.9	17.3	8.9	58.0	42.0	100
Mid-West	31.7	14.7	6.3	52.7	47.3	100
South-East	30.5	17.3	5.8	53.5	46.6	100
South-West	33.3	13.0	4.6	50.8	49.2	100
State	33.1	13.0	6.3	52.4	47.6	100

Source: CSO.

It is interesting to look at the breakdown of pension coverage by gender in Table 2.4. Pension coverage for females in the work force in 2004 was 10% less than for their male counterparts. Furthermore, 17.4% of males had personal pension cover only, compared to only 6.7% of females. Also, 7.4% of males indicated that they had both personal and occupational cover but only 4.8% of females had both forms of pensions.

Table 2.4: Pension Coverage in the State for Persons in Employment Aged 20 to 69 years, Q1 2004 (%) – By Gender

	Occupational Pension only	Personal Pension only	Both	Total Coverage	No Pension	Total
Male	31.4	17.4	7.4	56.3	43.7	100
Female	35.4	6.7	4.8	46.8	53.2	100

Source: CSO.

Not surprisingly, age is a key factor which influences the pattern of pension coverage and, as one would expect, pension coverage is lowest among the lower age groups. Table 2.5 gives a breakdown of pension coverage by age group. 76.8% of persons employed in 2004 in the age group 20-24 years had no pension cover whatsoever, and only 2.2% of this group had personal pensions as well as occupational pensions. Taking those under 35 years old in employment in 2004, 63% had no pension cover. However, 59.1% of all those employed, in the over 30 years category, had either occupational pension or personal pension coverage. This group has been the focus of recent pension targets.

Table 2.5: Pension Coverage in the State for Persons in Employment Aged 20 to 69 years, Q1 2004 (%) – By Age Group

Age	Occupational Pension only	Personal Pension only	Both	Total Coverage	No Pension	Total
20-24	19.1	1.9	2.2	23.2	76.8	100
25-34	35.4	9.4	5.7	50.5	49.5	100
35-44	37.6	16.6	8.0	62.2	37.8	100
45-54	35.0	17.1	7.7	59.8	40.2	100
55-69	28.9	19.6	6.4	54.8	45.2	100
30+ ³	35.4	16.3	7.4	59.1	40.9	100

Source: CSO.

It is interesting, when looking at a marital status breakdown of pension coverage as in Table 2.6, to note the higher percentage of pension cover amongst the 'married' group than the 'single', 'separated' and 'widowed' groups. This may be partially related to the responsibility of dependent children or may be related to age, income or employment factors.

Table 2.6: Pension Coverage in the State for Persons in Employment Aged 20 to 69 years, Q1 2004 (%) – By Marital Status

Age	Occupational Pension only	Personal Pension only	Both	Total Coverage	No Pension	Total
Single	29.0	7.4	4.8	41.2	58.9	100.0
Married	36.7	17.1	7.7	61.5	38.5	100.0
Separated	30.0	12.8	4.6	47.4	52.6	100.0
Widowed	22.8	17.9	6.4	47.1	52.9	100.0

Source: CSO.

³ The National Pensions Policy Initiative set a target of 70% supplementary pension coverage for all persons in employment aged 30+.

Table 2.7 shows the pension coverage for employed persons in 2004 compared to those who were self-employed. 54.4% of those in employment had pension cover compared to 43.1% for those in self-employment. This reflects the importance of occupational pensions.

Table 2.7: Pension Coverage in the State for Persons in Employment Aged 20 to 69 years, Q1 2004 (%) – By ILO Employment Status

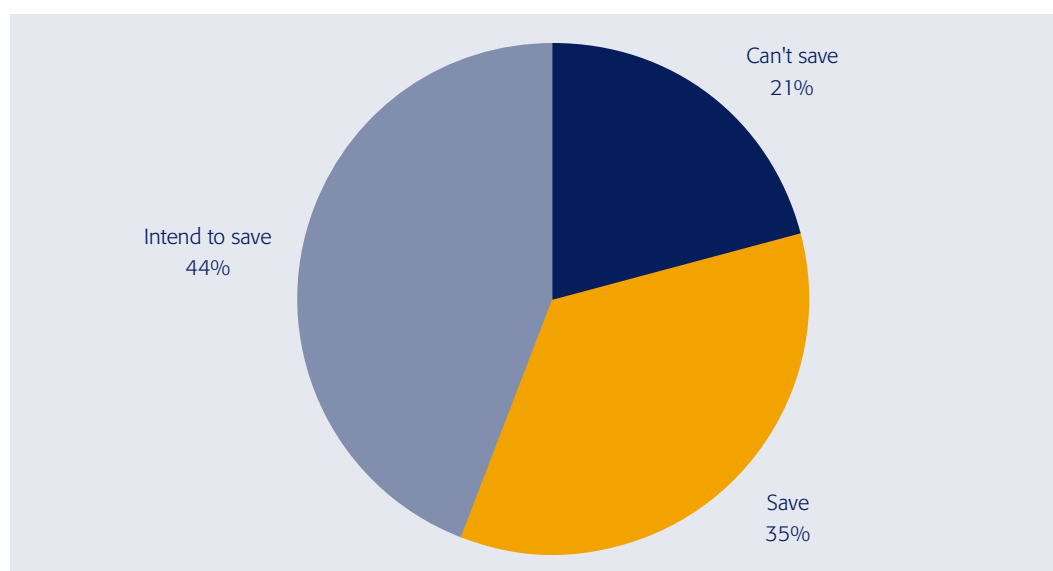
Age	Occupational Pension only	Personal Pension only	Both	Total Coverage	No Pension1	Total
Self-Employed and Assisting relatives	Not relevant	43.1	Not relevant	43.1	56.9	100.0
Employees	40.4	6.3	7.7	54.4	45.6	100.0

Source: CSO.

2.4 Selected Relevant Market Research Data

To assess the policy options it is important to examine the characteristics of savings behaviour. As part of the research programme, we examined existing market research data on savings. Figure 2.2 suggests that 35% of the population save with another 44% of respondents suggesting that they “intend to save”. Reflecting the affordability and other factors, 21% of respondents stated they can’t save.

Figure 2.2: Proportion of Adult Population Who ‘Save’, ‘Can’t Save’, and ‘Intend to Save’



Source: Lansdowne Market Research Undertaken for the Irish Insurance Federation

Market research also indicates on the percentage of respondents who state they are saving for pensions. The figures indicate that 48% of respondents are saving through a pension plan or through other means. This is broadly similar to the 52.4% that have a pension according to the CSO data.

Table 2.8: Percentage of Adult Population Saving for Pension

	%
Yes – Pension Plan	37%
Yes - Other Means	11%
No	43%
Don't Know	9%

Source: Lansdowne Market Research Undertaken for the Irish Insurance Federation.

The profile of savers is also of interest. Those who are saving for a pension tend to be older and a higher percentage of white collar professionals are more likely to save for pensions as well as those who are savers as set out in Table 2.9.

Table 2.9. Profile of Those *More Likely* to Save For Pension Through a Pension Plan

	%
35-45 year olds	43%
55-64 year olds	46%
Married men	44%
White collar professionals	53%
Those living in Dublin	47%
Those living in urban areas	45%
Those who are "Savers"	56%

Source: Lansdowne Market Research Undertaken for the Irish Insurance Federation.

Those that are less likely to save for pensions are younger, single and from a lower socio-economic class.

Table 2.10: Profile of Those *Less Likely* to Save For Pension

	%
18-24 year olds	77%
Single males	59%
Single females	52%
Unskilled working class	59%
Those living in 'Rest of Leinster'	54%
Those who 'Can't Save'	79%
Those in rural areas	50%

Source: Lansdowne Market Research Undertaken for the Irish Insurance Federation.

Survey data is also available on the principal source of income which individuals would intend to access upon retirement. 9% of respondents state that a personal savings/investment plan would be their main source of income, with 18% stating long-term savings/investments. 46% state that the State pension would be their main source of income when they retire, reflecting the relatively low level of pension coverage indicated by the other data sources.

Table 2.11: What Do People Expect To Be Main Income Source When Retired?

	%
The State pension	46%
A company pension you do contribute to	32%
A personal savings/investment plan	19%
Other long-term savings/investments	18%
Selling assets	7%
A company pension you do not contribute to	5%
Income from property	5%
Other	6%
Don't know	11%

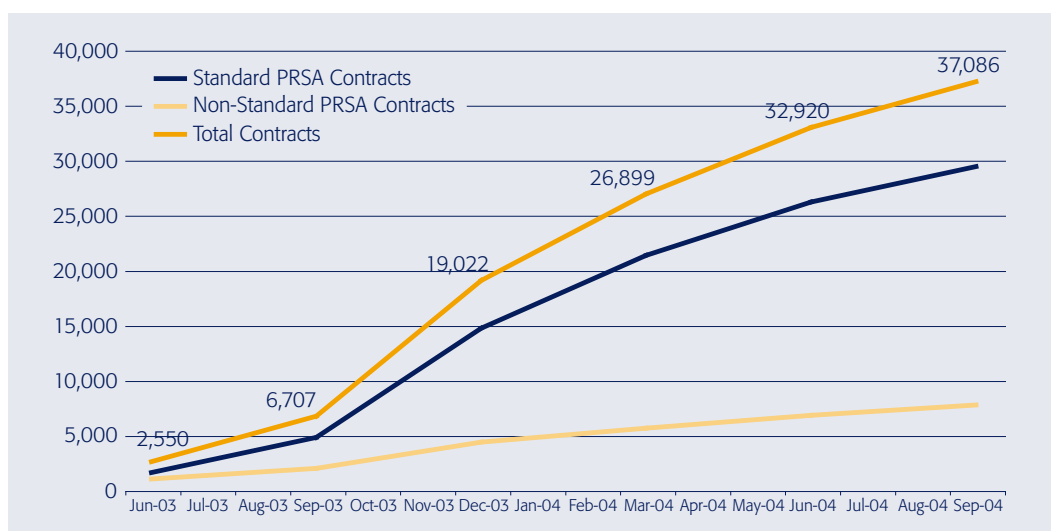
Source: Lansdowne Market Research Undertaken for the Irish Insurance Federation.

2.5 Trends in PRSA Take-Up

An issue for pensions policy and for this study is the trend in PRSAs. The first PRSAs were approved by the Pensions Board in February 2003 and we understand this new pensions product was introduced in June 2003 and offered a simple and portable pension product that was potentially attractive for consumers.

The trend in PRSAs take-up is illustrated in Figure 2.3 below. There has been a steady increase in PRSA contracts since June 2003, although the rate of increase appears to be slowing down. At end September 2004, there were an estimated 37,086 contracts. This suggests that pensions coverage has increased since the last CSO survey reported in previous sections but not markedly. It also suggests that a significant acceleration in take-up will be required if the target for pensions provision is to be met.

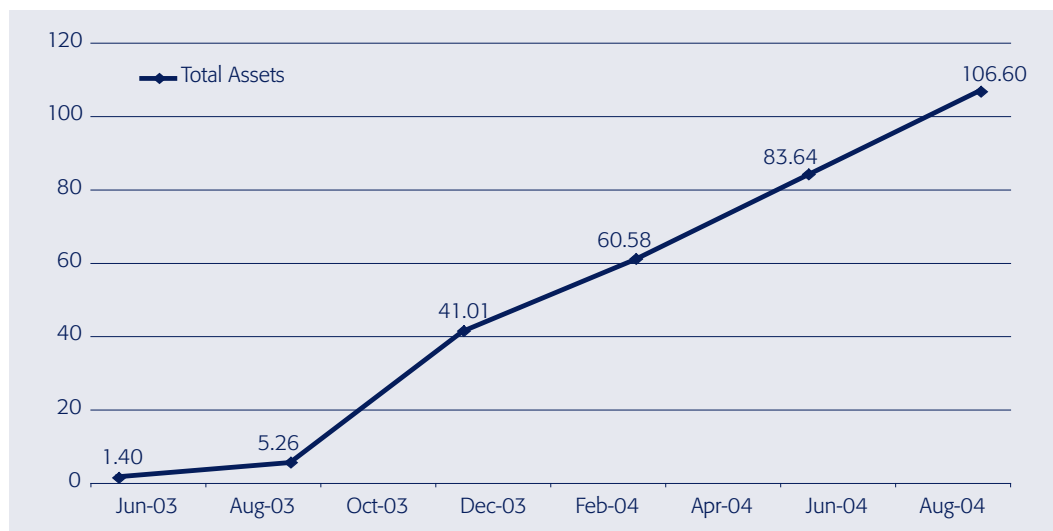
Figure 2.3: Trends in Pensions Take-Up



Source: The Pensions Board.

Data on the total amount of assets in PRSAs are also available from the Pensions Board. The data suggest that total assets amount to €106 million in August 2004.

Figure 2.4: Trends in Total Assets (€ Millions)



Source: The Pensions Board.

As previously mentioned, age is undoubtedly a significant factor which influences the take up of pension cover. The following tables look at various aspects of PRSA pensions broken down by age.

In Table 2.12 the age profile of those with standard and non-standard PRSAs is shown. Those in the 25 to 34 age bracket have the highest number of both standard and non-standard PRSAs, which to an extent is encouraging. The numbers fall significantly when you look at those aged 55 and over.

Table 2.12: Standard and Non-Standard PRSAs by Age Band

Age	Standard	Non-Standard
24 and under	1,658	393
25 – 34	5,922	1,674
35 – 44	3,866	1,193
45 – 54	2,316	667
55 and over	938	314

Source: The Pensions Board.

A similar picture emerges when we look at contributions, both individual and employer contributions, by age band (see Table 2.13 below). The majority of individual contributions come from those in the 35 to 54 age bracket, while the largest proportion of employer contributions are for those in the 25 to 44 age bracket.

Table 2.13: Individual Contributions & Employer Contributions by Age Band

Age	Individual Contribution Total	Employer Contribution Total
24 and under	€520,542.41	€79,784.89
25 – 34	€6,399,703.76	€678,228.55
35 – 44	€11,173,654.42	€732,366.48
45 – 54	€12,332,539.79	€509,126.69
55 and over	€8,791,136.80	€218,754.84

Source: The Pensions Board.

The average pension contributions by age band vary and increase significantly with age, the highest individual contributions being paid by those aged 55 and over (€7,022). Average employer contribution also increases with age profile, however, average contribution by employer for those aged 45-54 (€171) is almost the same as for those aged 55 and over (€175). Considerably lower contributions occur in the age band of 24 and under and here, the average employer contribution is €39.

Table 2.14: Average Contributions by Age Band

Age	Average Individual Contribution	Average Employer Contribution
24 and under	€254	€39
25 – 34	€843	€89
35 – 44	€2,209	€145
45 – 54	€4,134	€171
55 and over	€7,022	€175

Source: The Pensions Board.

2.6 Conclusions

The main conclusions of available information on pensions coverage in Ireland are:

- The CSO data for the first quarter of 2004 suggest that 52.4% of persons in employment aged between 20-69 have a personal or occupational pension.;
- This is a marginal increase on 2002, but markedly below the target set by the NPPI and accepted by Government;
- Market research data suggest that those less likely to save and make a pensions provision are younger, single and from a lower socio-economic class;
- There has been an increase in take-up of PRSA pensions;
- Average employee contributions to PRSAs are modest and employer contributions are negligible.

3 Trends in SSIA Savings

We have also accessed data on trends in SSIA's. SSIA's represent a very significant savings initiative which is important for overall savings and pensions policy. Data below are for 2001 to 2004. These include:

- "Subscriptions" which are the total monthly amount contributed by depositors to their savings accounts;
- "Tax Credit" which is the monthly total Exchequer contribution appropriate to the "Subscriptions" in Col. 2 reduced by the tax deducted on ceased accounts and withdrawals;
- "Tax Credit Payout" is the payout pattern of the Exchequer contribution shown in Col. 3. This contribution is made on a month behind basis, for example, the contribution for January subscriptions is paid in February.

For the period 2001 to end-November 2004, total subscriptions equalled €6,281.2 million. This is well above expectations and it is plausible that this may have adversely affected take-up of PRSA pensions although the evidence on this is incomplete. The total tax credit provided by the Exchequer amounted to €1,537 million.

Table 3.1: Monthly Revenue Cashflow Figures Relating to the Special Savings Incentive Scheme

	Subscriptions in year - €m	Tax Credit in respect of year - €m	Tax Credit Payout in year (i.e. Exchequer Cost) - €m
2001	356.6	88.8	71.0
2002	1,859.30	459.6	433.0
2003	2187.1	532.7	532
2004 *	1878.2	455.9	501
Total	6281.2	1537	1537

Source: Department of Finance. * Year to End-December

Table 3.2 shows that over 1.1 million people opened accounts, which is well over half the persons employed in the economy. Interestingly, there has actually been a slight decrease in the number of active SSIA accounts since the deadline for opening such accounts in April 2002. The number of active accounts fell by 5% between April 2002 and December 2003. This may reflect the economic slow down over this period and the restrictions on further sales after that date.

Table 3.2: Number of Active Accounts

As of:	Number
31st December 2001	398,214
30th April 2002	1,170,208
31st December 2002	1,143,418
31st December 2003	1,113,880

Source: Department of Finance.

Data are available on when accounts were opened. Almost half (49.8%) of all those holding SSIA accounts in 2003, only opened their account in April 2002 – the deadline for doing so. Only 3.8% have held their accounts since May 2001. Table 3.3 also shows the cumulative gross value of savings and associated tax credits to end of 2003.

Table 3.3: Percentage of Current SSIA Accounts in 2003 by Date of Commencement (May 2001 – April 2002)

Month of Commencement	% of account holders 2003	Cumulative gross value of subscriptions and associated tax credits to end of 2003 (€m)	% of Gross Value at end of 2003
May 2001	3.8	312.1	5.7
June 2001	7.4	600.1	10.9
July 2001	5.3	414.9	7.5
August 2001	3.7	281.3	5.1
September 2001	3.1	216.6	3.9
October 2001	3.1	208.3	3.8
November 2001	3.5	223.1	4
December 2001	3.4	230	4.2
January 2002	3.1	318.2	5.8
February 2002	4.7	273.4	5
March 2002	9.1	439.3	8
April 2002	49.8	1,997.80	36.2
Total	100	5,515.1 ⁴	100

Source: Department of Finance.

3.1 Subscription Levels

The average monthly subscription to SSIA accounts between December 2001 and December 2003 was €162.50 (compared to average PRSA contribution of €172.5). Table 3.4 shows the average monthly subscription for each period and indicates a slight increase each year since April 2002.

Table 3.4: Average Monthly Subscription

Month	Amount
Dec-01	€179
Apr-02	€148
Dec-02	€158
Dec-03	€165

Source: Department of Finance.

At the end of 2003, 40% of those with SSIA accounts were paying the maximum monthly amount of €254, while only 4% were paying the minimum of €12.50 per month.

⁴ This gross figure is inclusive of €57m in respect of funds that have been withdrawn from accounts, funds in accounts that have been ceased and funds in accounts that have matured during the years 2001 to 2003.

Table 3.5: Monthly Subscription Levels at End-2001, End-2002 and End-2003

Monthly Subscription Level	At 31/12/2003 %	At 31/12/2002 %	At 31/12/2001 %
Minimum €12.50	4	3	2
€12.50 - €59.99	17	20	11
€60 - €149.99	26	29	28
€150 - €253	13	11	6
Max €254	40	37	53
	100	100	100

Source: Department of Finance.

It is interesting to see in Table 3.6 below, that, in each of the three years, over 80% of account holders are in the 'low' and 'medium' income categories. In 2003, 17.1% of account holders were categorised as 'high income'.

Table 3.6: Monthly Subscription Levels at End-2001, End-2002 and End-2003

Income Category	% of account holders 2003	% of account holders 2002	% of account holders 2001
Low	37.5	38.2	33.1
Medium	45.3	45	47.7
High	17.1	16.8	19.2

Source: Department of Finance.

An estimation of the percentage of taxpayers who fall into the three income categories is given in Table 3.7. Comparing these numbers with the figures in Table 3.6 suggest that while most SSIA account holders are in low to medium income categories in percentage terms a higher percentage of high income tax payers have SSIA accounts.

Table 3.7: Estimated % of Taxpayers in Each Income Bracket 2001

% of Taxpayers in Each Income Bracket	
Taxpayers with Income less than €20,000	63.8%
Taxpayers with Income between €20,000 and €50,000	30.1%
Taxpayers with Income of more than €50,000	6.1%
Total	100.0%

Source: Revenue Commissioners.

3.2 Age Profile of SSIA Subscribers

SSIAs have been successful at reaching age groups that tend not to be savers. The data shows that 19.9% of account holders are aged 20-29. Moreover almost a quarter are in the 30-39 age bracket. Continuation of this saving trend for certain groups post SSIA could provide a significant boost to pension coverage if these savers could be directed towards pension take-up.

Table 3.8: Percentage of SSIA's Held by Each Current Age Group in 2003

Age Range (Years)	% of SSIA's
< 20	0
20 – 29	19.9
30 – 39	24.9
40 – 49	22.5
50 – 59	17.6
60 – 69	10.1
70 – 79	4
80 – 89	0.8
90 or over	0.2

Source: Department of Finance.

3.3 Market Research on SSIA's

Market research indicates that of those owning SSIA's, 47% said they would describe themselves as 'savers', but over half of them said they always *intended* to save or *cannot* save (see Table 3.9).

Table 3.9: Of Those Owning SSIA's

	% Having SSIA
'Savers'	47%
'Can't Save'	8%
'Intend to Save'	34%

Source: Lansdowne Market Research Undertaken for the Irish Insurance Federation.

When asked what they intended to do with the proceeds of their SSIA's, 8% said they would spend it immediately, and roughly the same amount (9%) said they would reinvest some or all of it in a pension or use for retirement. Looking at Table 3.10 we can see that 41% of account holders intend spending some or all of the proceeds of their SSIA's immediately, 16% said they will save or reinvest it all, and a significant 33% don't know what they will do with the money. This suggests that while there will not be any inevitable growth in pensions as a result of SSIA proceeds there is significant potential to stimulate pension take up from SSIA proceeds.

Table 3.10: Intentions with SSIA's

	%
Spend it immediately	8%
Spend some immediately and spend rest later	11%
Spend some immediately and save or reinvest the rest	22%
Save or reinvest it all	16%
Invest some or all in a pension plan/use for retirement	9%
Don't know	33%

Source: Lansdowne Market Research Undertaken for the Irish Insurance Federation.

3.4 Conclusions

The main conclusions from our analysis of SSIA savings are:

- SSIA savings have well exceeded expectations, with over 1.1 million account holders;
- The Exchequer costs to-date are €1.5 billion;
- Subscriptions average €165 per month similar to the average PRSA contribution;
- 40% of account holders are saving the maximum amount;
- 38% of respondents indicated that they would save all or part of their savings, but only 9% suggested an intention to invest all or some in a pension plan or to use for retirement.

4 Evidence on Pensions from the Household Budget Survey

4.1 Introduction

The section presents relevant data from the large scale Household Budget Survey (HBS) undertaken by the Central Statistics Office. The HBS is a survey of a representative random sample of all private households in the State. The main purpose of the HBS is to determine in detail the current pattern of household expenditure in order to update the weighting basis of the Consumer Price Index. The maintenance of a detailed diary of household expenditure over a two-week period by the surveyed households is thus the main distinguishing feature of the HBS. Detailed information is also collected on all sources of household income and on a range of household characteristics and contributions, such as pensions contributions.

A total of 7,644 households participated in the 1999-2000 HBS. In this section we summarise average private pension contributions in Ireland focussing on the differences in contributions made by private households across different income groups/deciles. It should be borne in mind that HBS data are collected at the *household* level and not at an *individual* level.

4.2 Analysis of HBS Data

Table 4.1 presents average weekly household expenditure on pension fund premiums as of 1999/2000. The data suggests that the average across all households in the State was €10.78 per week, or €562.07 per annum. The average disposable income across all households in the sample was €552, implying that the average proportion of disposable income spent on pension contributions was 1.95%. This average, of course, varies significantly across households.

Table 4.1: Average Weekly Household Expenditure on Pension Fund Premiums – 1999/00 - Euro

	State
Household Expenditure on Pension Fund Premiums	€10.78
Total Household Disposable Income	€551.57
Household Expenditure on Pension Fund Premiums as a % of Total Household Disposable Income	1.95%

Source: Central Statistics Office, Household Budget Survey.

One key determinant of the level of pension contributions is likely to be the income level of a household. Table 4.2 presents average weekly household expenditure on pension fund premiums by income decile. A decile is defined as any of nine points that divide a distribution (such as the income distribution of a sample of households) into equal intervals, where each interval contains one-tenth of the observations (or in this case one-tenth of the households in the sample). So, the first decile (Decile 1) contains the 10% of households in the HBS with the lowest incomes, while the tenth decile (Decile 10) contains the 10% of households in the HBS with the highest incomes.

The data presented in Table 4.2 shows considerable variation in private pension fund contributions across income deciles. For example, households in Decile 1 spent an average of only €0.04 per week (€2.09 per annum) on pension fund premiums, while those households in Decile 10 spent an average of €44.69 per week (€2,330.14 per annum). There will of course also be variation in spending within, as well as across, income deciles. It is interesting to note that private pension fund contributions are monotonically increasing with income i.e. as income rises so too do contributions.

Table 4.2 also presents estimates of household expenditure on pension fund premiums as a percentage of total household disposable income, across household income deciles. The estimates show a range of 0.04% to 3.13% of disposable income spent on private pensions. Households with higher incomes spend higher proportions of their income on pension contributions.

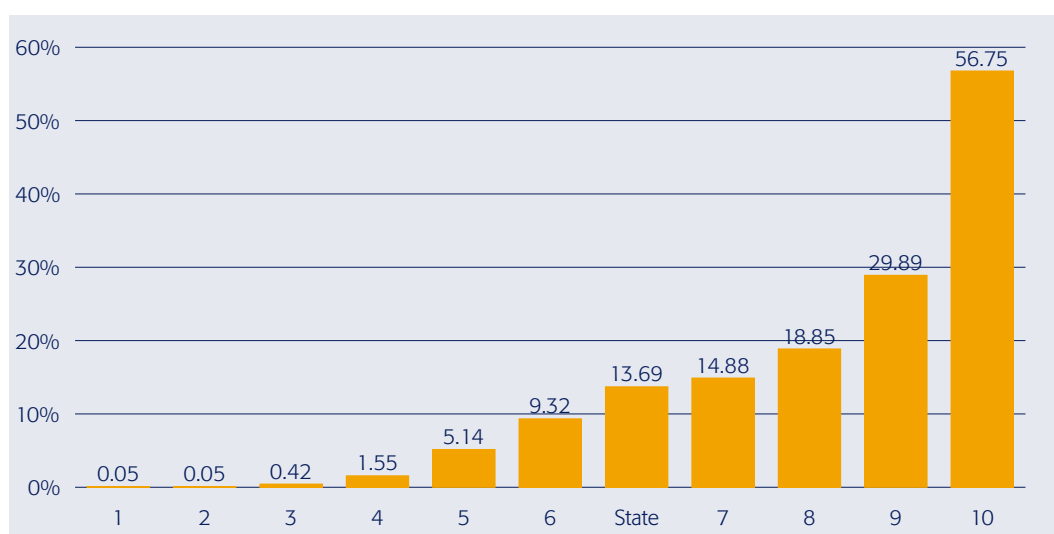
**Table 4.2: Average Weekly Household Expenditure on Pension Fund Premiums
By Income Decile – 1999/00 - Euro**

	Decile									
	1	2	3	4	5	6	7	8	9	10
Household Expenditure on Pension Fund Premiums	0.04	0.04	0.33	1.22	4.05	7.34	11.72	14.84	23.54	44.69
Total Household Disposable Income	106	174	249	332	423	516	618	743	926	1,429
Household Expenditure on Pension Fund Premiums as a % of Total Household Disposable Income	0.04	0.02	0.13	0.37	0.96	1.42	1.90	2.00	2.54	3.13

Source: Central Statistics Office, Household Budget Survey.

Figure 4.1 presents a graphical representation of average weekly household spending on pension premiums. The upward trend in the level of expenditure is evident in the chart. It also shows that those in Deciles 7 to 10 have above-average expenditures on private pension contributions while those in Deciles 1 to 6 have below average spending.

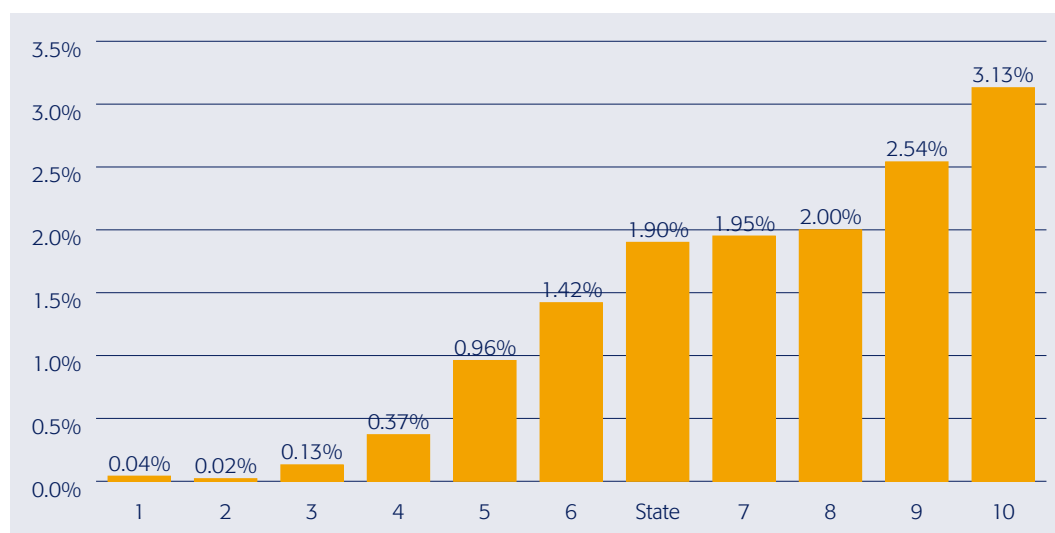
**Figure 4.1: Average Weekly Household Expenditure on Pension Fund Premiums
By Income Decile – 1999/00 - Euro**



Source: Indecon analysis of HBS data.

Figure 4.2 presents a graphical representation of household spending on pension premiums as a percentage of household disposable income. Once again the upward trend in the level of expenditure is evident in the chart. Figure 4.2 shows that those in Deciles 8 to 10 have above-average relative (to income) expenditures on private pension contributions while those in Deciles 1 to 7 have below average relative spending.

Figure 4.2: Household Expenditure on Pension Fund Premiums as a % of Total Household Disposable Income – 1999/00 - %



Source: Indecon analysis of HBS data.

4.3 Summary

The analysis in the section shows that there is considerable variation in private pension fund contributions across households with different levels of disposable income. In particular, private pension fund contributions are monotonically increasing with income i.e. as income rises so too do contributions. There will of course also be variation in spending within, as well as across, income deciles. Households with higher incomes also tend to spend higher proportions of their incomes on private pension fund contributions.

5 Evidence from New Indecon Market Research

5.1 Introduction

The section presents analysis of survey data specially obtained for this study and commissioned by Indecon and undertaken by TNS mrbi. In particular the analysis focuses on a number of potential barriers to increasing pension coverage in Ireland as well as the likely impact of a number of pension-related initiatives. The survey was based on a representative sample of adults (i.e. males and females aged 15 or more) and respondents were selected for interview through random digit dialling (RDD).⁵

The survey included quota controls for region, by age within sex and social class within sex. These controls ensure that the final sample reflects the profile of the national population aged 15+.⁶ The sample size of the survey was 933 adults aged 15+ years in the Republic of Ireland. Interviewing was conducted from November 30th to December 9th, 2004. The sample was weighted to represent the adult population in the Republic of Ireland aged 15+.

Respondents were asked a number of questions in relation to: ownership of selected financial products including pension products and SSIA's; potential barriers to increasing pensions coverage; the likely impact of enhanced tax allowances; and the impact of allowing transfers of SSIA monies into pensions. This section sets out the results of the survey and analysis of the data.

5.2 Ownership of Financial Products

Survey respondents were asked a number of questions, including a question relating to ownership of financial products:

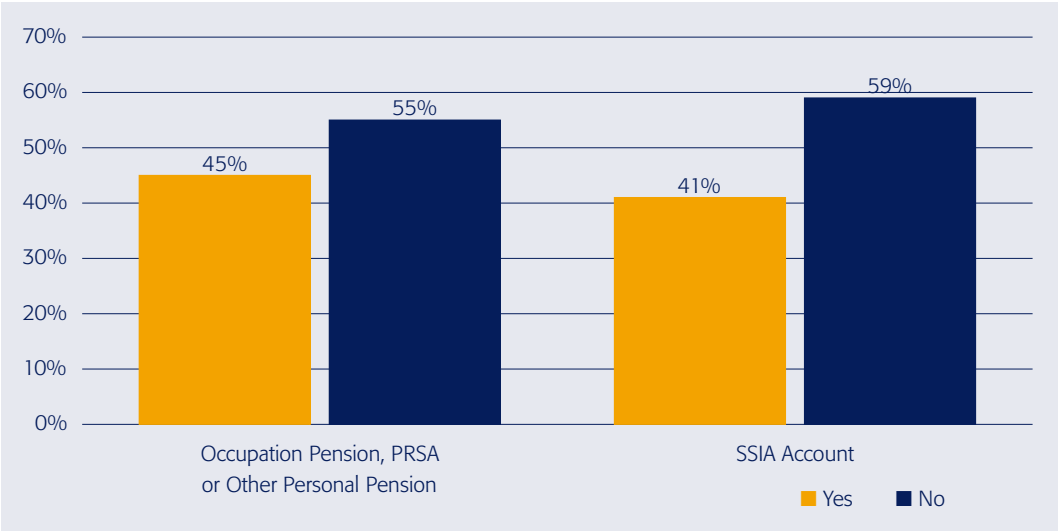
"Please indicate whether you have either of the following financial products?

- Occupation Pension, PRSA or Other Personal Pension;
- SSIA Account"

Figure 5.1 sets out a summary of the responses.

Overall, 45% of respondents indicated they had an occupational pension, PRSA or other pension product. The remaining 55% indicated they did not have a pension. In relation to Special Savings Investment Accounts (SSIAs), 41% of respondents have this investment while 59% do not. As expected, there was considerable variation in ownership of both pensions and SSIAs with age, with much higher proportions of older respondents owning these products compared to younger respondents.

Figure 5.1: Ownership of Financial Products



Source: Indecon commissioned TNS mrbi survey.

5 This method of respondent selection ensures that ex-directory households are as likely to be selected for interview as listed households.

6 Supervision of the interview procedure is carried out throughout the fieldwork period.

5.3 Potential Barriers to Increasing Pensions Coverage

Respondents were also asked their views in relation to a number of potential barriers to increasing pensions coverage in Ireland:

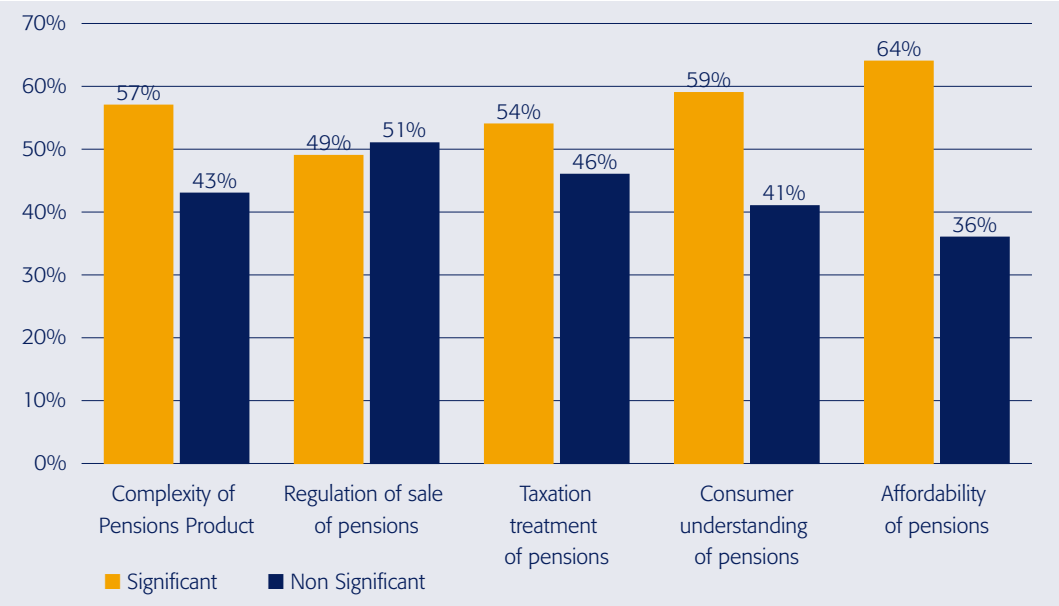
“In your view, are the following potential barriers to increasing the coverage of pensions in Ireland significant or not significant?”

- Complexity of pension products;
- Regulation of sale of pensions;
- Taxation treatment of pensions;
- Consumer understanding of pensions; and,
- Affordability of pensions.”

The findings of the survey in relation to potential barriers are summarised in Figure 5.2. The potential barrier identified by the highest proportion of survey respondents as a significant barrier was “affordability of pensions”. Overall, 64% suggested this to be a significant barrier, while 36% suggested it was not significant. A high proportion of respondents also identified “consumer understanding of pensions” and “complexity of pensions products” as significant (59% and 57% respectively). A majority of respondents also identified “tax treatment of pensions” as significant (54%).

Indecon fully accepts that while consumers are in the best position to evaluate the complexity of pension products and their understanding of pensions, as well as whether affordability or taxation treatment represents a potential barrier they are likely to be less competent than providers to evaluate the impact of regulation of sale of pensions. This aspect was however included to obtain a consumer perspective on regulatory issues and is not meant to constitute the basis for evaluating regulatory issues.

Figure 5.2: Potential Barriers to Increasing Pensions Coverage



Source: Indecon commissioned TNS mrbi survey.

There was also some variation in views across age groups and social classes to these potential barriers. For example, higher proportions of respondents in social class AB saw the complexity of pensions as a significant barrier to increasing pension coverage compared to respondents in social class F – see Table 5.1 below.

Table 5.1: Does “complexity of pensions products” represent a barrier to increasing the coverage of pensions in Ireland? – Responses by social class

Social Class	Significant	Not Significant
AB	64%	36%
C1	60%	40%
C2	65%	35%
DE	50%	50%
F	43%	57%
Total	57%	43%

Source: Indecon commissioned TNS mrbi survey.

In relation to variation in views across age groups, this was less pronounced though some variation is evident. For example, lower proportions of older respondents see complexity of pension products as a significant barrier to increasing coverage. Table 5.2 sets out a breakdown of responses by age group. The fact that very high percentages of individuals in the 20 – 44 age group see complexity of pension product as a significant barrier is important given that this group is a target for increased pension take-up.

Table 5.2: Does “complexity of pension products” represent a barrier to increasing the coverage of pensions in Ireland? – Responses by age category

Age	Significant	Not Significant
15 – 19	52%	48%
20 – 24	59%	41%
25 – 34	66%	34%
35 – 44	59%	41%
45 – 54	59%	41%
55 – 64	54%	46%
65+	44%	56%
Total	57%	43%

Source: Indecon commissioned TNS mrbi survey.

Taxation treatment of pensions

An analysis of views on the issue of whether the taxation treatment of pensions represent a barrier to increasing pensions coverage is presented in Table 5.3 below. Interestingly, the percentages indicating this is a significant barrier is very high among the 25 – 34 and 35 – 44 age groups. These groups are potentially important target groups.

Table 5.3 : Does the “taxation treatment of pensions” represent a barrier to increasing the coverage of pensions in Ireland? – Responses by age category

Age	Significant	Not Significant
15 – 19	58%	42%
20 – 24	53%	47%
25 – 34	60%	40%
35 – 44	58%	42%
45 – 54	50%	50%
55 – 64	56%	44%
65+	44%	56%
Total	54%	46%

Source: Indecon commissioned TNS mrbi survey.

An analysis of the views on taxation treatment of pensions as a barrier by socio-economic group is presented in Table 5.4. The lower percentages among the DE and F groups may reflect the issue of affordability for these groups although a sizeable minority of these categories also view the taxation treatment as a significant barrier.

Table 5.4 : Does the “taxation treatment of pensions” represent a barrier to increasing the coverage of pensions in Ireland? – Responses by social class

Social Class	Significant	Not Significant
AB	66%	34%
C1	60%	40%
C2	59%	41%
DE	44%	56%
F	44%	56%
Total	54%	46%

Source: Indecon commissioned TNS mrbi survey.

Consumer understanding of pensions

The issue of consumer understanding of pensions is also a significant issue. This is particularly evident in the important 20 – 24, 25 – 34 and 35 – 44 groups as indicated in the table below.

Table 5.5 : Does “consumer understanding of pensions” represent a barrier to increasing the coverage of pensions in Ireland? – Responses by age category

Age	Significant	Not Significant
15 – 19	53%	47%
20 – 24	64%	36%
25 – 34	68%	32%
35 – 44	66%	34%
45 – 54	59%	41%
55 – 64	54%	46%
65+	46%	54%
Total	59%	41%

Source: Indecon commissioned TNS mrbi survey.

Affordability of pensions

Affordability of pensions is seen by all age groups as a significant barrier. This suggests that while incentives and improved product design is likely to be important for some groups the issue of affordability will remain a barrier which will present private contributions to pension schemes.

Table 5.6 : Does “affordability of pensions” represent a barrier to increasing the coverage of pensions in Ireland? – Responses by age category

Age	Significant	Not Significant
15 – 19	66%	34%
20 – 24	64%	36%
25 – 34	68%	32%
35 – 44	70%	30%
45 – 54	66%	34%
55 – 64	59%	41%
65+	54%	46%
Total	64%	36%

Source: Indecon commissioned TNS mrbi survey.

5.4 Likely Impact of Enhanced Tax Allowances

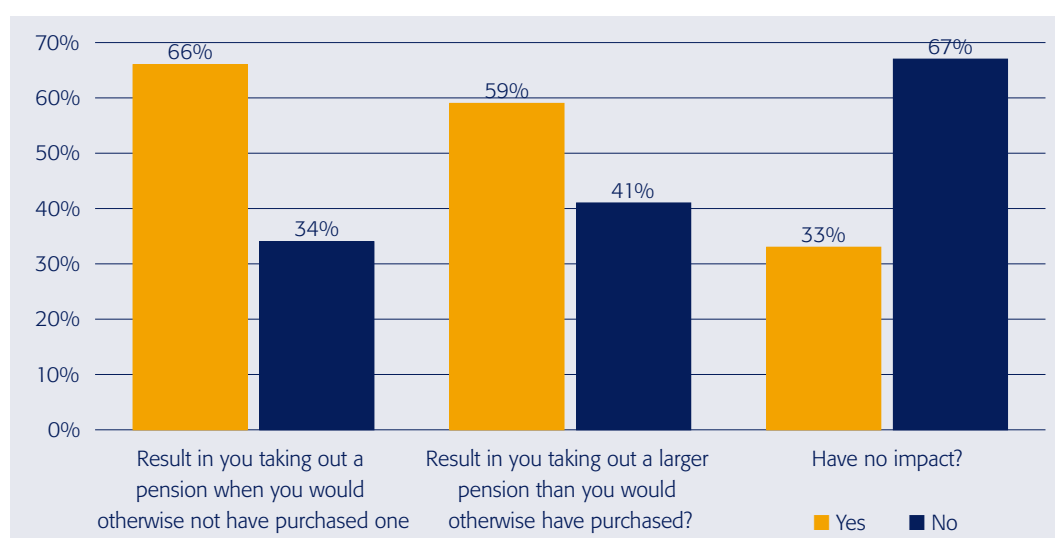
Survey participants were also asked their views on the likely impact of enhanced tax allowances:

“If the Government introduced enhanced tax allowances on pension contributions would this be likely to:

- Result in you taking out a pension when you would otherwise not have purchased one?
- Result in you taking out a larger pension than you would otherwise have purchased?
- Have no impact?”

Figure 5.3 presents a summary of responses to this issue. According to the survey, 66% of respondents suggested they would be more likely to take out a pension (if they did not already have one), if the Government introduced tax allowances on pension contributions. Overall, 59% of respondents indicated that the improved tax allowances would result in them taking out a larger pension, while only 33% indicated that this type of policy intervention would have no impact.

Figure 5.3: Likely Impact of Enhanced Tax Allowances



Source: Indecon commissioned TNS mrbi survey.

Result in you taking out a pension?

The views of different age groups on whether enhanced tax allowances would result in individuals taking out a pension when they would not otherwise have purchased one is presented in Table 5.7 below. The figures indicate very encouraging potential interest arising from appropriate targeted tax incentives. The lower percentage of over 65 may reflect a range of factors including income level and existing pension provisions.

Table 5.7 : Would enhanced tax allowances result in you taking out a pension when you would otherwise not have purchased one? – Responses by age category

Age	Yes	No
15 – 19	66%	34%
20 – 24	75%	25%
25 – 34	80%	20%
35 – 44	67%	33%
45 – 54	70%	30%
55 – 64	58%	42%
65+	39%	61%
Total	66%	34%

Source: Indecon commissioned TNS mrbi survey.

Interestingly the AB social group demonstrate one of the highest levels of percentage interest in securing pensions if there were enhanced tax allowances. Of significance, however, is the fact that a majority of all social groups suggested that enhanced tax allowances would result in them taking out a pension. This is not to suggest that all of this group would invest in a pension but highlights the potential interest in such incentives.

Table 5.8 : Would enhanced tax allowances result in you taking out a pension when you would otherwise not have purchased one? – Responses by social class

Social Class	Yes	No
AB	73%	27%
C1	68%	32%
C2	72%	28%
DE	58%	42%
F	62%	38%
Total	66%	34%

Source: Indecon commissioned TNS mrbi survey.

5.5 Impact of Allowing Transfers of SSIA Monies Into Pensions

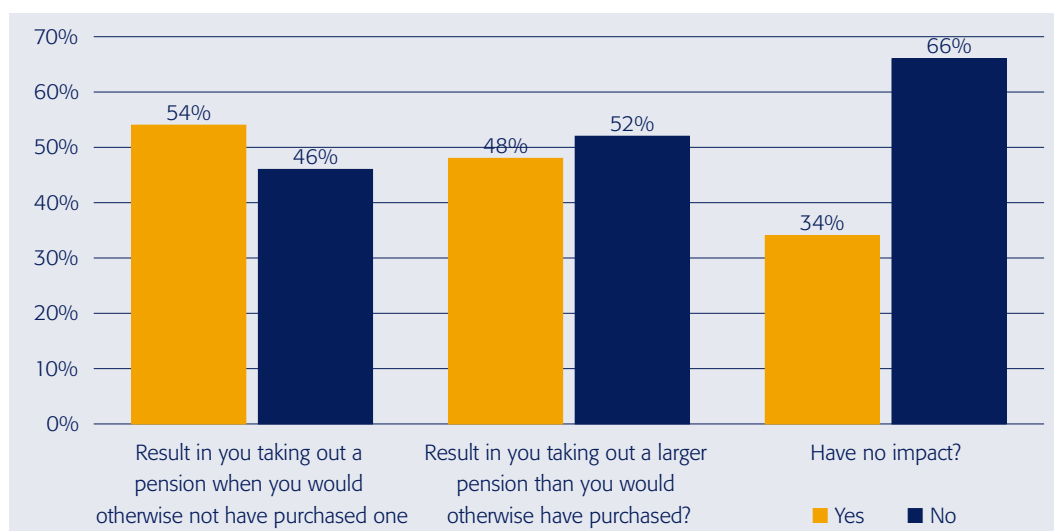
Finally, survey participants were also asked their views on the likely impact of tax relief for transferring SSIA investments into pensions:

"If tax relief was allowed on transferring SSIA money into pensions would this be likely to:

- Result in you taking out a pension when you would otherwise not have purchased one?
- Result in you taking out a larger pension than you would otherwise have purchased?
- Have no impact?"

Figure 5.4 presents a summary of responses to this question (see Annex 4 for a breakdown by age and social class). Overall, 54% of respondents indicated they would be more likely to take out a pension if the government introduced tax relief on SSIA funds transferred to pensions. 40% of respondents indicated that the tax relief would result in them taking out a larger pension, while only 34% indicated that this option would have no impact.

Figure 5.4: Impact of Allowing Transfers of SSIA Monies Into Pensions



Source: Indecon commissioned TNS mrbi survey.

Result in you taking out a pension?

The views of different age groups on whether tax relief on transferring SSIA funds into pensions would be likely to result in them taking out a pension is presented in Table 5.9. While for some age groups such as over 55 a majority indicated this would not result in an increase in their pension take up, for other age groups a majority suggested it could have this impact.

Table 5.9: Would allowing transfers of SSIA monies into pensions result in you taking out a pension when you would otherwise not have purchased one? Responses by age category

Age	Yes	No
15 – 19	57%	43%
20 – 24	66%	34%
25 – 34	54%	46%
35 – 44	60%	40%
45 – 54	65%	35%
55 – 64	47%	53%
65+	25%	75%
Total	54%	46%

Source: Indecon commissioned TNS mrbi survey.

An analysis of the impact of providing tax allowances on transfer of SSIA funds into pensions by socio-economic group is presented in the table below. The figures highlight higher percentage responses by AB social groups who may not need a pension as much as others. This suggests the need for careful targeting of any new incentives.

Table 5.10: Would allowing transfers of SSIA monies into pensions result in you taking out a pension when you would otherwise not have purchased one? Responses by social class

Social Class	Yes	No
AB	67%	33%
C1	57%	43%
C2	55%	45%
DE	48%	52%
F	44%	56%
Total	54%	46%

Source: Indecon commissioned TNS mrbi survey.

5.6 Summary

The section has presented survey data specially commissioned by Indecon for this study that focuses on a number of potential barriers to increasing pension coverage in Ireland, as well as the likely impact of a number of pension-related initiatives.

Respondents were asked a number of questions in relation to: ownership of selected financial products including pension products and SSIA; potential barriers to increasing pensions coverage; the likely impact of enhanced tax allowances; and the impact of allowing transfers of SSIA monies into pensions.

Overall, 45% of respondents indicated they had an occupational pension, PRSA or other pension product, while 41% have SSIA's. The survey evidence suggests that much higher proportions of older respondents own these products compared to younger respondents.

In relation to potential barriers to increasing pension coverage in Ireland, the barrier identified by the highest proportion of survey respondents as a significant barrier was affordability of pensions - 64%. High proportions of respondents also identified consumer understanding of pensions and complexity of pensions products and taxation as significant.

The survey evidence suggests that 66% of respondents would be more likely take out a pension if the government introduced tax allowances on pension contributions. 59% indicated that the improved tax allowances would result in them taking out a larger pension, while only 33% indicated that this type of policy intervention would have no impact.

In relation to tax relief on SSIA funds transferred to pensions, 54% of respondents suggested they would be more likely take out a pension, while 40% indicated that this tax relief would result in them taking out a larger pension. 34% indicated that this option would have no impact.

6 Incentives and Pension Coverage

6.1 Introduction

This section looks at a number of issues in relation to the incentives available to increase pension take-up and pension savings. It begins with a brief description and general overview of the relationship between tax relief and pensions. It then focuses in greater detail at a number of issues of relevance to this study in examining the effectiveness of tax relief as incentives for pension take-up and pension savings. This section draws on international research and reports including a recent report published in the UK by the Pensions Policy Institute.⁷ Overall the international research has tended to focus on tax incentives and that is the main focus of this section.

6.2 Tax Relief and Pensions

The current system of tax relief on pension contributions in Ireland provides significant incentives for investing in pension saving particularly for those on higher incomes. Within the current system there are a number of direct tax advantages that can be seen as incentives to encourage pension saving.

In the UK, over half of tax relief paid on pension contributions is in respect of contributions from employers.⁸

Tax relief on private pension contributions is seen by many however as regressive. This is because “higher earners receive a higher rate of tax relief, and so receive more state support for a given level of private pension contribution. Higher earners are also more likely to belong to private pension schemes, and so be making contributions that attract tax relief.”⁹ Hence, overall this means that most tax relief is received by those classified as high-earners. In the UK for example, “55% of tax relief on individual and employee pension contributions is received by 2.5 million higher rate tax payers.” Some analysis of the incident of pension tax relief by income category in Ireland is discussed elsewhere in this report.

6.3 Tax Relief as an Incentive for Pensions Saving

Incentives, including tax incentives, are used in many countries to encourage people to save. For example, governments frequently aim to increase the amount people save by contributing some financial incentive – this has the effect of increasing the return on saving. According to PPI (2004), the UK has a history of private pension provision, supported by a system of tax relief and incentives. Despite significant annual expenditure on incentives however, and apparent success in building up a large stock of pension fund assets, there is still said to be a ‘savings gap’ in the UK.

The PPI (2004) report considers a number of issues pertinent to the debate in Ireland, including, *inter alia*:

- Tax incentives and the way people save;
- Complexity of tax incentives;
- Tax incentives and target groups;
- Tax incentives and total saving;
- Tax incentives and the ‘savings gap’; and,
- Other factors affecting the savings decision.

In this section we present an overview of some of these issues.

7 PPI (2004), “Tax Relief and Incentives for Pension Saving – A Report by the Pensions Policy Institute for Age Concern England.”

8 PPI calculations presented in PPI (2004).

9 PPI (2004).

6.3.1 Tax incentives and the way people save

Tax incentives can affect the way that people save. For example, countries that offer tax relief on pensions often have large numbers of people making individual private pension provision:

- 8 million people between ages 25 and 64 (50%) make contributions to Registered Retirement Savings Plans (RRSPs) in Canada;¹⁰
- More than 40 million households (40%) make contributions to Individual Retirement Accounts (IRAs) in the US;¹¹
- Over 4 million employees and self-employed people (15%) report making contributions to a personal pension in the UK.¹²

According to PPI (2004), there is some research that suggests that “most of this pension saving comes at the expense of other forms of saving”.¹³ It should be noted however that “tax incentives are not the only driver for increased individual private pension saving. In New Zealand the number of people with individual private pensions almost doubled between 1990 and 2001, despite New Zealand not having any tax incentives for private pension saving.¹⁴ However, in the Irish context it is noteworthy that only 24% of the New Zealand labour force now has individual private pensions.”

6.3.2 Complexity of tax incentives

In Ireland, current tax incentives for pensions saving are based mainly around the marginal rate of income tax – this is also the case in the UK. According to PPI (2004), “the different tax rules, limits and even language makes it difficult for people to understand the value of tax relief in their own specific circumstances. Many low- and middle-income savers do not know if they pay tax on their savings, or what the value of relief would be to them.”¹⁵

PPI (2004) also claims that “people have said that they prefer other, simpler, forms of saving incentive.” They cite Vidler (2002) in support of the assertion that “more people say they would be highly likely to increase their saving if a matching contribution, or an increased employer contribution were available compared to higher tax relief [Indecon emphasis].” The issue of simplicity in both pension products and in any tax relief is an important criteria in designing any new incentives which we take account of in our review of options.

6.3.3 Tax incentives and target groups

The analysis of Household Budget Survey data presented in this report clearly shows that while middle- to high-income individuals and households do invest in private pensions, this is not the case to the same extent for low-income earners. Evidence from the UK suggests that although low to middle income individuals do save¹⁶, “they are not strongly influenced by the availability of tax relief, and most do not use ISAs”.¹⁷ The reason for this is that benefits of tax relief are low for low-earners who do not pay as much tax as higher-earners. Also of significance is the high numbers of individuals who now have incomes below the taxable limits in Ireland implying that these individuals do not have any tax incentive to invest in pensions. The issue of affordability is also of key importance.

¹⁰ PPI (2004) calculation based on data from Statistics Canada.

¹¹ Munnell (2003).

¹² PPI analysis of the Family Resources Survey 2002/3.

¹³ Sandler (2002), OECD (1994), Whitehouse (2003).

¹⁴ PRG (2003).

¹⁵ See Whyley and Kempson (2000 b).

¹⁶ For example, for a ‘rainy day’ or longer term.

¹⁷ PPI (2004) and Whyley and Kempson (2000).

6.3.4 Tax incentives and total saving

Higher levels of savings and pensions are generally seen as desirable by policymakers for a number of reasons¹⁸ leading to government policies and initiatives that are designed to increase both the numbers of savers and the amounts that people save or invest in pensions. In fact, it is often the case that policymakers will look to target lower-income and other groups who do not have large savings.

However, according to PPI (2004) “there is no evidence to suggest that tax incentives increase the overall level of saving [Indecon emphasis]”. PPI (2004) refers to a number of studies to support this assertion e.g. Littlewood (1998), Sandler (2002), NZT (2001) and Gale *et al* (2004). There are, according to the authors, a number of reasons for this:

- “Tax incentives are complex, making them difficult to understand;
- Tax incentives often do not appeal to their target group. Low to middle income groups (who are traditionally low savers) pay lower rates of tax, and so gain less from reduced tax liabilities; and,
- The amount that people want to save is determined by a range of factors not linked to tax relief or rates of return, such as income and affordability.”¹⁹

This, however, depends in part on the current economic position and the characteristics of savers. It also depends on the relative scale of incentives and this may be important in Ireland in considering the SSIA initiative.

6.3.5 Tax incentives and the ‘savings gap’

The PPI (2004) report defines the ‘savings gap’ as “the difference between the amount people need to save each year to achieve a reasonable retirement income, and the amount they are actually saving.”

In the UK, it is generally accepted that there is a savings gap, but no consensus on how big it is. The UK Government estimates that between 3 million and 13 million people may be ‘undersaving’. Interestingly, for New Zealand, where there is no tax relief for pension saving, it has been suggested that there is no ‘savings gap’, although Indecon notes the low percentage of the labour force that has industrial private pensions in New Zealand.²⁰ In Ireland clear targets have been set by the Pension Board concerning the scale of underinvestment in pensions and the timescale to address this.

6.3.6 Other factors affecting the savings decision

PPI (2004) sets out a number of other factors that are important for personal decisions to save. They cite a number of factors that tend to impact negatively on savings:

- Many people have difficulty imagining the future, or aversion to long-term planning rather than concerns about the effective rate of return on saving.
- People with low or insecure incomes, or supporting a family, often find they do not have enough money to save in a pension.

6.4 Conclusions

Some research has suggested that tax incentives are often used to encourage people to save more, but their impact on overall savings ratio is more uncertain. It is clear, however, that if the incentives are understood and are targeted they can impact on the level of savings. Tax incentives can also encourage pension rather than other types of saving. This highlights the need for careful targeting of pension provisions.

¹⁸ For example: to encourage people to be more secure financially; to spread their income more evenly over a lifetime; to reduce state expenditure.

¹⁹ PPI (2004).

²⁰ See Grant Scobie and Le Thi Van Trinh (2004).

7 Discussion of Policy Options and Recommendations

7.1 Introduction

The objective of this study is to identify cost effective policy options that could assist in extending pensions coverage. In this chapter we outline a number of policy options to extend coverage. Our analysis is based on a rigorous review of the factors which are hindering pension coverage. Some factors, such as affordability, may not be amenable to change by fiscal incentives. We believe, however, that there is a case for limited targeted additional incentives.

7.2 Key Policy Considerations

Our analysis shows that a large percentage of the population have no or very limited pensions coverage although as indicated by the latest data from the CSO, some progress has been made since the Report of the National Pensions Policy Initiative²¹ in extending pensions coverage. However, coverage is well below the interim targets recommended by the NPPI and accepted by Government.

Accordingly, the background to this policy discussion is an assumption that there is inadequate coverage and that there is a significant gap between current coverage levels and the interim targets recommended by NPPI.

In addition, it needs to be stressed that Government pension's policy has been evolving. In recent years the basic State Pension has been increased in excess of growth in earnings and the Government is committed to achieving the target of having the State Pension equal to 34% of the average manufacturing wage as recommended by NPPI. PRSAs have been introduced as a new pensions product supported by Government initiatives. Also of significance is the fact that the Exchequer provides tax relief at a taxpayers' marginal tax rate for contributions into private pensions schemes. For standard rate taxpayers, relief is available at 20% while relief is available at 42% for higher rate taxpayers.

In May 2002 the Government introduced an additional savings scheme (SSIA), that provided an Exchequer funded top-up payment of €1 for every €4 saved. This, not surprisingly, attracted significant funds and has encouraged savings including amongst sections of the population where pensions coverage may be inadequate.

The total Exchequer cost of supports for private savings and pensions are set out in Table 7.4, and indicate that very significant government incentives are provided for the pension sector. It should be stressed that this is in part deferred tax payments, as pension income is taxable. The figures show that over 670,000 employees secured tax relief on pensions and a further 109,000 benefit from tax relief on retirement annuity pensions. For comparison, it is interesting to note that the numbers employed in the economy, on a seasonally adjusted basis, was 1,631,000 in Jun-Aug 2000 and 1,865,000 in Jun-Aug 2004. The number of taxpaying units was 1,710,897 in 2000/2001.

Table 7.1: Pension-Related Costs and Number of Recipients – 2000 / 2001

	Cost - €m	Numbers Benefiting
Tax Relief - Employees	471.9	670,500
Employers' Contributions	646.2	n/a
Retirement Annuity Premiums	205.0	109,600
SSIA	532.7 (2003)	1,113,880 (2003)

Source: Revenue Commissioners and Department of Finance.

21 Securing Retirement Income, National Pensions Policy Initiative Report of the Pensions Board.

Details on the cost of tax reliefs for different classes of taxpayers are not available from official sources. However, the Household Budget Survey data indicates that the vast bulk of this relief is provided to higher income taxpayers. Some official information is available for tax relief for contributions to "Retirement Annuity Premiums". Details for the short-tax year are overleaf. The value of contributions allowed at the 20 and 42 per cent tax rates is estimated at €78 million and €368 million respectively, amounting to €446 million.

Table 7.2: Income Tax 2001 (Short "Year") - Retirement Annuity - By Range of Gross Income

Range of Gross Income			Totals		
From (€)	From (€)	Number of Cases	Amount of Deduction	Reduction in Tax	Average Deduction
-	6,000	1,258	1,301,889	76,588	1,035
6,000	8,000	1,217	1,131,858	159,747	930
8,000	10,000	1,976	2,066,245	318,130	1,046
10,000	12,000	2,779	3,131,978	538,747	1,127
12,000	15,000	5,489	6,725,589	1,228,558	1,225
15,000	17,000	4,446	5,613,493	1,067,199	1,263
17,000	20,000	7,513	10,476,115	2,039,761	1,394
20,000	25,000	12,222	19,723,266	4,505,791	1,614
25,000	27,000	4,567	8,276,351	2,214,991	1,812
27,000	30,000	6,350	12,331,704	3,457,396	1,942
30,000	35,000	9,441	20,838,925	6,506,746	2,207
35,000	40,000	7,942	20,490,572	7,354,258	2,580
40,000	50,000	11,427	37,038,299	14,847,501	3,241
50,000	60,000	6,807	29,985,541	12,417,840	4,405
60,000	75,000	5,741	35,653,618	14,883,125	6,210
75,000	100,000	4,543	41,479,867	17,310,850	9,131
100,000	150,000	3,951	56,115,725	23,514,956	14,203
150,000	200,000	1,753	38,561,305	16,149,432	21,997
Over	200,000	2,635	98,693,919	41,399,977	37,455
Totals		102,057	449,636,259	169,991,594	4,406

Source: Department of Finance.

In previous sections of this report we presented detailed data and analysis on pensions. It is useful in considering policy options to summarise some of the key conclusions from this detailed analysis. The analysis suggested the following:

- The CSO data, for the first quarter of 2004, indicated that 52.4% of persons in employment aged between 20-69 have a pension;

- This is a marginal increase on 2002, but markedly below the targets recommended by NPPI in 1998 of achieving supplementary pension provision for those at work aged 30 – 65 of 62% after 5 years, 66% after 10 years, and 70% ultimately;
- Market research data suggest that those likely to save and make a pensions provision are younger, and from a lower socio-economic class;
- Average PRSA employee contributions are modest and employer contributions are negligible;
- SSIA savings have exceeded expectations, with over 1.1 million account holders;
- The Exchequer cost to-date of the SSIA's tax credit is €1.5 billion;
- Annual subscriptions average €165 per month similar to the average PRSA contribution. 40% of account holders are saving the maximum amount;
- While there is a reasonable take-up of SSIA accounts amongst low income groups, middle and higher income groups are disproportionately represented;
- 38% of respondents who were SSIA account holders indicated that they would save all or part of their SSIA savings but only 9% propose to use the proceeds on a personal pension;
- The objective of policy proposals is to enhance pensions coverage amongst those groups that currently have inadequate coverage, particularly among low to middle income groups;
- There are significant exchequer costs associated with existing incentives for private pensions and the available evidence is that the benefits of current incentives accrue mainly to middle and higher income groups
- In addition, there is a significant group of employees outside the tax net that are not incentivised by existing pension-related tax reliefs;
- The marginal benefits to taxpayers on the higher band are, of course, greater than the benefits to "standard band taxpayers" on the standard rate;
- The SSIA's have been successful at increasing the overall level of savings and encouraging savings amongst groups with inadequate pensions provision – notwithstanding the fact that, in common with most savings initiatives, there may be an element of deadweight;
- There may be scope to take targeted initiatives to ensure that a percentage of the SSIA savings are retained as savings and investments.

7.3 Barriers to Taking-Up a Pension

In assessing the take-up of pensions we need to consider the barriers that may be preventing individuals from saving adequately for their pension.

As discussed previously, Indecon commissioned a survey of a representative sample of the population to assess their views on pensions issues. Specifically, we asked about their views on the potential barriers to increasing the coverage of pensions in Ireland. The results are set out in Table 7.3 and indicate that the affordability of pensions and consumer understanding of pensions were identified as significant barriers by a majority of the survey respondents. Other factors rated as significant included the complexity of pension products and the taxation treatment of pensions.

Table 7.3: Views on the potential barriers to increasing the coverage of pensions in Ireland

	Significant	Not Significant
Complexity of pension products	57%	43
Regulation of sale of pensions	49	51
Taxation treatment of pensions	54	46
Consumer understanding of pensions	59	41
Affordability of pensions	64	36

Source: Indecon Commissioned TNSMRBI Survey

As part of our research we also asked a small number of industry PRSA providers for their views of the significance of the following potential barriers to increasing the coverage of pensions in Ireland:

- Complexity of pension product
- Regulation of sale of pensions
- Taxation treatment of pensions
- Consumer understanding of pensions
- Affordability of pensions

The results from a small number of leading companies are set out in table 7.4. It is not suggested that these views are necessarily representative but are of interest for illustrative purposes.

Table 7.4: Views on the potential barriers to increasing the coverage of pensions in Ireland

	Significant	Not Significant
Complexity of pension product	50%	50%
Regulation of sale of pensions	50%	50%
Taxation treatment of pensions	100%	0%
Consumer understanding of pensions	100%	0%
Affordability of pensions	100%	0%

Source: Indecon Survey of Sample of Industry Practitioners

Issues such as the complexity of pensions and consumer understanding of pensions are important as barriers to increasing pension provision which must be addressed by the industry. The taxation treatment of pensions is also seen by both individuals and by the industry as one of the barriers to increasing the coverage of pensions. As we will discuss in detail below, the current system provides no pensions-related relief to persons earning less than €14,200 per annum and modest benefit to some taxpayers on incomes just below this.

The issue of the regulation of the sale of PRSAs and pensions is also relevant. Industry sources have suggested that brokers, who are significant players in the market, believe that the regulation of the new PRSA product can be prohibitive relative to likely returns. It is argued by the industry that the sale of a PRSA is unnecessarily complex and the actual sales process is consuming and expensive. This may be partly due to the complex procedure that needs to be followed.

It is, however, important to stress that regulations may be necessary to protect consumer interests. This is an issue which we will return to when considering options for the extension of coverage, but it is clear that regulatory issues require on-going examination and could affect the take-up of PRSAs and other pension products.

7.4 Assessment Criteria

Before assessing various options it is worth considering the criteria that we use in assessing options. These are set out in Table 7.5 and discussed below.

Table 7.5: Assessment Criteria for Evaluation of Policy Options

1.	Equity
2.	Focus on target group
3	Effectiveness/Efficiency (including deadweight considerations)
4.	Simplicity

Source: Indecon

7.4.1 Equity

It is important that scarce Exchequer resources are used in an equitable manner. Current supports for private pensions provision disproportionately benefit higher income groups. It is essential that the proposed initiatives focus on groups that do not currently benefit significantly from current reliefs.

7.4.2 Focus on target group

Related to the issue of equity is the question of ensuring that proposals are targeted on those groups that currently have inadequate coverage. The available evidence suggests that these include low to middle income groups and that additional proposals of a fiscal/financial nature should focus primarily on these groups.

7.4.3 Effectiveness/Efficiency

Effectiveness involves the extent to which a proposal is likely to be effective in achieving its objective. A proposal may be effective at meeting a particular objective and a key question is whether it is cost effective. Deadweight is an important consideration in both effectiveness and efficiency. Deadweight is where some or all of the investment would have taken place in the absence of the tax subsidy. For example, if a fiscal proposal provides relief to individuals that are already providing adequately for their pension without the need for additional supports then the incentives may not impact on behaviour. In such circumstances part of the Exchequer cost is a deadweight cost. Related to effectiveness is efficiency of the policy instruments used.

7.4.4 Simplicity

It is important that proposals are as far as possible are easy for consumers to understand and easy to implement for both the Government, where relevant, and for the pension industry. In particular, administrative and regulatory costs should be minimised to the extent feasible.

7.5 Assessment of Options

In considering options for extending pensions coverage it should be noted that there are a large number of potential options and for each option there are a number of variations. In this section, we focus on the most commonly suggested policy options and a number of new proposals which we feel are appropriate. Policy options that could assist in extending coverage fall into a number of categories. These are set in Table 7.6.

Table 7.6: Types of Potential Policy Options

1.	Fiscal and other financial supports to employees and/or employers
2	Industry Marketing / Product Development
3.	Regulatory / Legislative Reform of Pensions Market

Source: Indecon

Most of the policy options suggested by the industry involve additional Government supports, funded by the Exchequer, to encourage pension take-up. For example, many of the SSIA related proposals fall into this category.

The second set of proposals relates to potential development of pensions products or marketing initiatives by the sector that could encourage a higher take-up. The complexity of pensions products for consumers is a barrier to extending coverage and this issue has implications for the sector.

The final set of proposals relate to regulatory/legislative reforms. Of course, there may be a trade-off between the need to protect the consumer and lowering the transactions costs. This is an issue that arises for all pension, savings and investment products. Legislative issues relate to the extent or otherwise of mandatory pensions and other aspects impacting on coverage.

7.6 Discussion of Various Options

In this section we discuss the various options for encouraging a greater take-up of pensions. The main options which have been suggested to Indecon are outlined in table 7.7 as well as a number of additional options which have been developed by the consultancy team. Each of these are discussed below.

Table 7.7: Option for Fiscal and Other Financial Supports

(1)	Continue with the Status Quo
(2)	increase in pension contribution limits
(3)	Exempt 23% exit tax on capital gains on SSIA accounts
(4)	Pension related tax credit
(5)	Family income support tax credit uplift for pension contributions
(6)	Tax incentive for child pension accounts
(7)	Employers PRSI savings due to employee contributions to be transferred in employees pension fund
(8)	Further Support for PRSAs
(9)	Detailed review of regulatory framework for PRSAs
(10)	Industry action to increase consumer understanding and improved marketing
(11)	Incentives for Employees

Source: Indecon

Continue with the Status Quo

The first policy option which Indecon believes must be the benchmark for any other options is to continue with the status quo. This has the advantage that it would not involve additional Exchequer costs. In addition, it would not add further uncertainty into the market given the rapid change in recent years.

The disadvantage of the current position is that it would not take account of the benefits of measures which would direct part of SSIA monies into pensions and thereby reduce the inflationary impact on the economy. Also the status quo would not address the need to increase the level of pension take up.

Once-Off Increase in Pension Contributions Limits for All SSIA Account Holders

The SSIA accounts will mature over the period May 2006 to May 2007. Several proposals have been suggested to encourage the transfer of some of this SSIA money into savings and pensions. These include the proposal to have a once-off increase in pension contributions limits for all SSIA account holders. Our market research suggests that in the absence of new initiatives only a very small percentage of these funds will be directed to pensions.

Under existing policy, individuals can make pension contributions up to a certain percentage of their income and avail of the tax relief at either the standard or marginal rate depending on the their tax position. The limits are set out in Table 7.8. It has been suggested to Indecon these limits be increased for all SSIA account holders on a once-off basis to encourage the transfer of SSIA funds into pension accounts. This would benefit individuals who have sufficient SSIA funds which are in excess of their current allowable limit for pension contributions.

Table 7.8: Current Contribution Limits

Age	Contributions as a % of Earnings
Under 30	15%
30-39	20%
40-49	25%
50+	30%

Source: Indecon

It has been suggested to Indecon that the benefits of this proposal include the following:

- It would minimise the negative macroeconomic effects of SSIA funds flowing into inflationary expenditures;
- It could encourage an increase in pensions take-up;
- It could encourage existing pension holders to increase their contributions.

Indecon accepts that these benefits are valid but believe that despite these benefits there are a number of downsides to this proposal as follows:

- This is not targeted on those that do not at present have a pension or have inadequate pension provisions;
- There are no benefits from this proposal to those without a tax liability and it provides only a modest benefit to those on low incomes in the tax net;
- SSIA account holders have already secured very substantial Exchequer subsidies and an increase in the current limits for all SSIA account holders could provide additional benefits regardless of whether the individuals currently had adequate pension provision.

Once-Off Increase in Pension Contribution Limits for Individuals with Underestimated Contributions

We believe however that a modified version of the proposal on pension limits discussed above and targeted on selected groups would merit consideration. In particular we believe there would be merit in refining the proposed increase in pensions contributions to allow for the transfer of SSIA monies for individuals who have not used their total allowable contribution in recent years. For example, an individual earning €50,000 and aged 30-39 could have made a maximum contribution of €10,000 in each of the previous three years. Lets' assume that a person has been contributing €5,000 each year; this equates to an unused contribution of €15,000 over the three-year period. One option is to permit individuals to add this amount to the individual's contribution limit in either of the two years in which the SSIA will be encashed.

This proposal would particularly focus resources on those persons without any pension or who have underinvested in pension provision in recent years. This minimises deadweight effects, in as much as persons making the maximum contribution would not benefit, and it would tend to focus resources on those individuals not making adequate contributions at present.

We believe also that the once-off timetable could be effectively used by the pension industry in their marketing effects to encourage pension take-up and could also assist in minimising the inflationary impact of SSIA related expenditures. We propose that this once off use of underutilised allowances should be linked with the years of the ending of SSIA but should be available to individuals regardless of whether they hold an SSIA account or not. This would therefore not restrict this additional incentive only to those who were in a position to afford SSIA investments.

Exemption of Exit Tax on Capital Gains on All SSIA Accounts on Transfer to a Pension

A proposal suggested to Indecon relates to the exemption of the 23% exit tax on the total gains of all SSIA accounts on maturity. For convenience, we assume that the capital gain on the funds invested equals €2 billion. At a tax rate of 23%, this equates to a maximum tax liability of €460 million. A proposal from the Irish Insurance Federation, in their 2005 pre-budget submission, suggests that this tax should be waived if the monies are transferred into a pension fund. If we assume that even 50% of the capital gain is transferred, the cost to the Exchequer is €230 million. Indicative calculations of the cost of the cost of this proposal under different scenarios are set out below:

Table 7.9: Indicative Estimates of the Cost of waiving the Exit Tax

	€
Total Capital Gain	2 billion
@ 23% Exit Liability	460 million
Cost – Assumed 100% transfer to pensions	460 million
Cost – Assumed 50% transfer to pensions	230 million
Cost – Assumed 25% transfer to pensions	115 million

Source: Indecon

The arguments for and against this proposal are similar to the points raised earlier in relation of the increase in the contribution limit. There are a number of potential benefits for this initiative, but issues may arise in relation to equity, targeting and deadweight.

Exempt 23% Tax on Capital Gains on SSIA Accounts upon Transfer to Pension Fund Providing No Income Tax Relief is obtained on this Amount

Indecon believes that a modified version of the proposal to exempt 23% tax on capital gains has significant merits. Specifically we believe there is a strong case to exempt the exit tax for individuals who invest the capital gain in pensions provided the exempt amount does not result in additional income tax relief on transferring this capital gain into a pension fund. This could be exempt at source providing an ease of administration for pension contributions.

For high income tax payers this additional incentive would be of no interest but for those employees who are not in the tax net it would be a significant benefit and would also be of some limited benefit to those who are paying tax at the standard rate. This provision would also assist the sector in their marketing to secure wider pension coverage by highlighting to SSIA investors the potential ability to secure an exemption from the SSIA capital gain exit tax.

We would also be supportive of an exemption from any SSIA penalties for early withdrawals of SSIA funds provided they are invested in pensions.

Pension Related Tax Credit

The proposed exemption of SSIA capital gains exit tax for selected pensioners is a specific example of a credit or payment by the state to certain individuals who invest in pensions. This is of particular value to those who are not in the tax net. In this context it is useful to consider the wider issue of the introduction of tax credits to increase pensions coverage.

The introduction of tax credits seeks to provide incentives to take-out a pension for individuals who do not benefit under existing tax relief arrangements. A pension related tax credit would take a refundable form to non-taxpayers. The Minister for Finance in the 2005 Budget increased the thresholds at which an individual is exempt from tax and the income levels at which tax is paid at the higher rate. This will increase the number of number of taxpayers who receive no or limited pension-related tax relief under the current incentive arrangements as set out in Table 7.11. The introduction of a tax credit could be a significant incentive to increasing pensions coverage for some individuals in low to middle income groups.

Table 7.10: Distribution of Income Earners on the Income Tax File for 2005

	Exempt	Marginal Relief	Standard Rate	Higher Rate	Total
On a Pre-Budget Basis	590,457	13,735	620,239	685,848	1,910,279
Percentage of Taxpayers	30.9%	0.7%	32.5%	35.9%	
On a Post-Budget Basis	656,517	11,947	608,075	633,740	1,910,279
Percentage of Taxpayers	34.4%	0.6%	31.8%	33.2%	

Source: Department of Finance

The pre-Budget distribution forecasts the numbers of income earners, (assuming income growth for 2005), which would be in each tax band in 2005 if no Budget were introduced.

A jointly assessed married couple is treated as one tax case.

For some individuals with no or very low tax liability, the introduction of tax credits could encourage pensions take-up. There are various ways that pension tax credit could operate. It is suggested that the tax credit could be organised as a transfer with a pensions provider as is already the case with SSIA's as we believe this has distinct merits.

There are a number of different ways in which this could operate. One option would be to include the following:

- For the government to transfer a credit of a fixed sum to the pension providers; and/or
- For individuals to claim a tax credit equivalent to a percentage of the amount invested in a pension.

A tax credit for pensions would ensure the integration with the existing system and allow a taxpayer to claim the tax credit or relief under the existing system.

An example of how a tax credit system could operate for specific types of taxpayers could help in providing an explanation. For illustrative purposes, we set out an example of the potential operation of a system of pension tax credits. Table 7.11 shows the tax liability for single taxpayers at different income levels for the tax year 2005. Based on the recent Budget changes, single taxpayers would no longer pay tax at incomes below 14,200 and there is a relatively modest tax liability for incomes below the €29,600 tax band.

Table 7.11: Tax Liability for Single Persons - 2005

Gross Income	Tax Liability Before Tax Credit	Existing Tax Credit	Tax Due
6000	1200	2840	0
8000	1600	2840	0
10000	2000	2840	0
12000	2400	2840	0
14200	2840	2840	0
16000	3200	2840	360
18000	3600	2840	760
20000	4000	2840	1160
25000	5000	2840	2160
30000	6132	2840	3292
35000	8232	2840	5392
40000	10332	2840	7492
45000	12432	2840	9592
50000	14532	2840	11692
60000	18732	2840	15892
80000	27132	2840	24292
100000	35532	2840	32692
120000	43932	2840	41092

Source: Indecon

Table 7.12 shows the reduction in tax liability if we assume that each taxpayer contributes 10% of their income into a pension fund. Of course, individuals on modest incomes may not be in a position to make such a contribution but this example is for illustration only. The table shows that under the existing tax system individuals on incomes below €14,200 receive no tax benefits from making a pension contribution. The tax relief as a percentage of total pension contribution shows the distribution of the benefits of the existing reliefs.

Table 7.12 Changes in Tax Liability for Selected Pension Contributions - 2005

Gross Income	Pension Contribution @10 % of Earnings	New Tax Liability	Savings on Tax Liability under Current Tax Code	Tax Relief as a % of Pension Contribution
6000	600	0	0	0.0%
8000	800	0	0	0.0%
10000	1000	0	0	0.0%
12000	1200	0	0	0.0%
14200	1420	0	0	0.0%
16000	1600	40	320	20.0%
18000	1800	400	360	20.0%
20000	2000	760	400	20.0%
25000	2500	1660	500	20.0%
30000	3000	2560	732	24.4%
35000	3500	3922	1470	42.0%
40000	4000	5812	1680	42.0%
45000	4500	7702	1890	42.0%
50000	5000	9592	2100	42.0%
60000	6000	13372	2520	42.0%
80000	8000	20932	3360	42.0%
100000	10000	28492	4200	42.0%
120000	12000	36052	5040	42.0%

Source: Indecon

Table 7.13 shows the impact of the introduction of tax credits. First, we examine the implications of introducing a tax credit of €5 week. Under our example, we assume that taxpayers would invest at least €260 per annum in a pension and accordingly all would receive the minimum tax credit of €260. The effect of this is seen in the table as all individuals with incomes below amount €14,200 would benefit considerably compared with the current system. Overall, as it is a fixed payment, the additional benefits in percentage terms disproportionately benefit those on the lowest incomes.

Table 7.13: Impact on Tax Savings of Illustrative Tax Credit Scheme and Pension Contribution of 10% of Income

Gross Income	Savings on Tax Liability under Current Tax Code	Savings Assuming Additional €5 per Week Tax Credit	Tax Relief and Credit as a % of Pension Contribution
6000	0	260	43.3%
8000	0	260	32.5%
10000	0	260	26.0%
12000	0	260	21.7%
14200	0	260	18.3%
16000	320	580	36.25
18000	360	620	34.44
20000	400	660	33.00
25000	500	760	30.40
30000	732	992	33.06
35000	1470	1,730	49.42
40000	1680	1,940	48.50
45000	1890	2,150	47.77
50000	2100	2,360	47.20
60000	2520	2,780	46.33
80000	3360	3,620	45.25
100000	4200	4,460	44.60
120000	5040	5,300	44.17

Source: Indecon

Of course, there are alternatives to this approach, which would provide a tax credit as a percentage of contributions. In other words, the Government would provide a top-up as a fixed percentage of a pension contribution up to a maximum contribution and this has a number of advantages.

We believe that there are very strong arguments in favour of introducing a system of tax credits for pensions as it would provide significant benefits to individuals who do not benefit under the existing tax relief arrangements.

Pension Tax Credit Providing No Income Tax Relief is Obtained

An alternative approach would be to provide a pension tax credit provided no other income tax relief on pensions is obtained by the individuals securing the tax credit. This would represent an effective targeted measure with significant equity advantages. It would also focus the incentive on those groups which are less likely to have adequate pension provision. In the table below we illustrate using the €5 example the impact of this on different income categories. As outlined earlier a tax credit could be provided either in the form of a fixed amount (as in our example) or in the form of 20% of pension contribution in both cases it would only benefit those employees who have incomes below the taxable levels. However, if this was given direct to the pension provider as a matching contribution it may also increase the understanding and attractiveness of pension incentives to those on medium incomes.

Table 7.14: Impact of Illustrative Tax Credit Scheme Assuming it was Restrictive to Those Not Securing Income Tax Relief on Pensions

Gross Income	Impact of €5 Tax Credit
6000	260
8000	260
10000	260
12000	260
14200	260
16000	320
18000	360
20000	400
25000	500
30000	732
35000	1470
40000	1680
45000	1890
50000	2100
60000	2520
80000	3360
100000	4200
120000	5040

Source: Indecon

Family Income Support Tax Credit Uplift for Pension Contributions

A more limited version of this tax credit scheme would be to provide pension tax credits through modifications of family income supplement system. This could be provided as an uplift on the FIS amount for contributions to private pensions. The advantage of this would be that it would provide an incentive for pension take up of low income working families and there is an existing administrative mechanism by which this could be undertaken. It could also be introduced quickly at low exchequer costs. In the current calculation of the FIS payment we understand that relief is given for pension contributions which are a deduction from gross earnings. We would however, favour a more widespread introduction of a tax credit system as FIS would not provide any incentive to single individuals or those falling outside the FIS criteria but this would be a potentially welcome first step.

Tax Incentive for Child Pension Accounts

There are various proposals to establish special pension accounts for children in order to encourage the savings and pensions habit. There are a number of specific proposals suggested to Indecon that we discuss briefly in this section.

SIPTU has for some time been proposing the establishment of special pensions accounts for all children. Prior to Budget 2005 they put forward a detailed proposal suggesting that the basic rate of Child Benefit be increased to €150 per month (a target already set under national agreements) and that an extra 10%, (which would be €15 per month), should then be added and earmarked for pensions. This ‘from birth’ arrangement would apply to all children born after January 1, 2005. For children born prior to that date, they suggested that the Child Pension Accounts (CPAs) could be set up at the point when the child comes off Child Benefit (i.e. usually at age 17 or 18). This could be done by paying a lump sum, or “pensions start-up bonus” – equivalent to, say, six months Child Benefit – which would be used to set up their special pension account. SIPTU have suggested that this particular mechanism would spread the cost to the Exchequer over 17-18 years (as only 2 age cohorts would be covered each year, i.e. 0-1 and 17-18) and would mean that after that period virtually every young person below the age of 36 would have a personal pension account. This account could be added to, or used to supplement, pensions provided through social insurance, occupational pensions or other supplementary arrangements.

SIPTU also proposed that tax relief would be available for additional contributions to these child pension accounts (e.g. from parents, grandparents, etc.) with appropriate ceilings on any contributions for which tax relief could be claimed. SIPTU also believes that while the purpose of these CPAs would have to be the provision of a mechanism for ensuring very long-term savings, primarily for pension purposes, some early encashment of these funds would be desirable (e.g. a once-off chance to take 25% of the fund at around age 25 probably for housing purposes) and this would also add to their attractiveness.

Indecon would be supportive of considering utilising part of any future uplift in Child Benefit for this purpose.

The Irish Insurance Federation (IIF) have proposed a scheme with the establishment of a personal pension for every child in the State. The main elements, which are drawn directly from the IIF statement, are as follows:

- A personal pension account should be opened for every child in the country and the Government should deposit €10 a month into each child’s account until he/she turns eighteen. (Cost: €130 million per annum);
- A Sponsor(s) (e.g. a parent or guardian of the child) may make additional contributions to the child’s account of between €5-€50 per month over the same time period;
- For every €5 contributed by sponsors it is proposed that the government would contribute an additional €1;
- On the account-holder’s 25th birthday he/she may withdraw 25% of the current gross value of the fund tax-free if and only if he/she has been contributing a minimum of 5% of earnings when working. The remainder cannot be accessed until retirement.

IIF suggests the potential costs to the Exchequer of their proposal would be of the order of €180 million per annum.

The IIF submission has suggested that the benefits of this proposal are that:

- Every child in the country now has a growing pension fund from birth;
- The 18-25 rule would develop in the child/young adult a positive attitude to saving and a saving habit;
- The necessity for the State to put increasing funds aside to look after senior citizens will be reduced;
- This would lead to better-funded personal pensions.

Indecon believe that there are a number of issues regarding the child pension incentives including whether they would provide incentives to high income families who do not need the state assistance and whether they would result in genuine pension habits or simply represent a form of short-term savings which would be spent subsequently. There is also the issue of equity in terms of the treatment of spouses versus children. If this incentive was capped to a maximum of existing contribution levels the issue of discrimination between children of public servants and other groups in the labour market could arise.

Tax Relief on Children's Pensions Subject to Current Contribution Limits and Allowances to be at Standard Rate

If it is decided despite the issues raised above to introduce an incentive for children pensions we believe this should either be in the form of a tax credit or alternatively any new allowance should only be available at the standard rate of tax. Any relief on children's pensions could be subject to the adults current contribution limit, so that an individual currently securing maximum personal tax relief on pensions up to the current limits would not be eligible to secure additional relief for their children.

Employers' PRSI Savings to be Transferred to Employee Pension Funds

In our discussions with social partners and others on extending coverage, the question of mandatory provision was raised. In a number of the confidential submissions received from pension industry sources this was recommended. This approach has been adopted in a number of other countries but requires careful evaluation.

One specific aspect of this is whether it should be required for employers to transfer any PRSI savings when making deductions for employee contribution. This latter issue was examined by Coyle Hamilton in a recent study. We understand that the current position of the Policy Committee of the Pensions Board is that after much discussion it was felt that applying the employers PRSI savings to employees had administrative cost implications and it was felt this was not consistent with pensions simplification. Indecon believe that employers should be encouraged to contribute any PRSI savings and there is merit in considering more widespread employer incentives.

Further supports for PRSAs

There are also additional sets of proposals that suggest ways of underpinning the current PRSA framework. One proposal involves making a transfer from a PRSA fund to a State Fund, which would supplement an individual's social welfare pension. For example, an individual would purchase a given social welfare pension for a specified sum per week. The second related option involves the Government providing an additional top-up to PRSA funds to safeguard their value in the event of a fall in the funds value. A specific proposal is that for every €15 paid to a PRSA the state would provide a supplementary social welfare pension equal to €1. This is an additional support to individuals with PRSA.

These proposals, which were outlined in a recent paper²², propose supports, which may over time make PRSAs more attractive. However, we do not believe that they should be the immediate priority for policy action.

²² "Pension Provision in Ireland" - The Shape of things to come? By James R. Kehoe.

Detailed Review of Regulatory Framework for PRSAs

In terms of the regulation of PRSAs, there are concerns from pension industry sources about the limited impact of PRSAs on the market. A number of providers had stated that PRSAs had replaced personal pensions for many self-employed persons. For persons in non-pensionable employment it has been suggested that the impact so far has been limited.

A feature, which may have implications for coverage, is that we have been informed that brokers may be selling less than 20 % of PRSAs. Brokers are significant players in the overall pensions market and if these estimates are correct, the suggested lack of interest of brokers may be an issue in determining the take-up of PRSAs.

It is argued by some in the industry that the sale of a PRSA is unnecessarily complex and the actual sales process is time-consuming and expensive. This may be partly due to the procedure that needs to be followed and, specifically, what we have been informed is that a large number of processes need to be completed to finalise a PRSA sell. Some of these processes are required by IFSRA, some by the Pensions Board and some by the Revenue Commissioners. According to one provider contacted by the consultancy team, the following is the procedure that must be followed:

- Contact Referral Form to be completed;
- Terms of Business Letter to be provided;
- Factfind to be completed - Requirement to establish that PRSA is best advice for a particular client relating to their individual circumstances - also need to establish that client can effect a PRSA as opposed to an AVCPRSA or other pension product;
- IFSRA PRSA information leaflet to be provided;
- Company PRSA Brochure to be provided;
- Reason why letter to be provided - copy to be signed by client;
- PRSA Disclosure Information to be provided;
- PRSA Application Form to be completed - Application Form contains information specifically required by the Pensions Board for statistical purposes, PRSA Disclosure Declaration, Data Protection Declaration, Details of method of payment;
- Sec 30 receipt may be required if a payment is received;
- Evidence of individual's age to be obtained;
- Evidence of individual's PPSN to be obtained;
- Further detailed prescribed information issued to the client following the acceptance of the proposal and the issuing of the PRSA contract.

A further complicating factor is there are a number of regulators including IFSRA, The Revenue Commissioners and the Pensions Board overseeing the approval and sales processes. There are also concerns in the sector about the time taken to approve new products. A detailed investigation of whether this is the case or not is outside the scope of this assignment.

Given these regulatory issues, it is suggested by some in the sector that a number of steps could be undertaken. These include:

- Increasing the maximum allowable charges on Standard PRSAs;
- Reducing the level of administration involved;
- Reviewing the overall level of regulation involved;
- Make it easier to claim the tax relief.

Key Points from Meeting with IFSRA re: Pensions Board Study – Tuesday, March 8th, 2005

We understand from our consultations with IFSRA that the timing of commencement of PRSAs was in line with that of the commencement of IFSRA and that the regulatory structures pertaining to other products were essentially applied to PRSAs. Apart from its prudential function, the principal concern of IFSRA related to the manner in which PRSAs are sold.

IFSRA noted that while the PRSA was originally designed for a mass audience, the introduction of the non-standard product had meant that the product was more complicated than would have been the case if all PRSAs had standard characteristics.

In relation to the specific requirements when a consumer is taking out a PRSA, IFSRA noted that there was scope for some streamlining in this area. However, they stressed that while the regulator did not determine the level of information required as part of the 'Fact Find', it would be expected that the level of information required was greater in the case of the non-standard PRSA.

On the issue of the feasibility of combining some elements of the information requirements for opening a PRSA so that duplication is minimised, we understand that IFSRA would have no objection in principle, so long as minimum regulations were followed.

In relation to each element of the procedure that must be followed to open a PRSA, IFSRA noted the following and stressed that many of the requirements were common to all financial products:

- (i) The chief purpose of the Contact referral Form was to prevent 'cold-calling'.
- (ii) In relation to the Terms of Business Letter, IFSRA suggested that this was necessary to set down the business relationship, as in any other transaction.
- (iii) In relation to the fact-find, IFSRA stressed the need to distinguish between the standard and non-standard PRSAs, but accepted that there might be some scope to streamline this element in the case of the standard product.
- (iv) In relation to the 'Reason Why' letter, it was suggested that for a standard PRSA this need not be as comprehensive as for a non-standard PRSA.
- (v) Re: the Section 30 receipt – this is a standard legal requirement.
- (vi) Requirements for evidence of age and PPSN were in common with other products.

Overall, IFSRA suggested that in any further review of regulations on PRSAs, there would continue to be merit in distinguishing between the standard and non-standard PRSA in relation to the regulatory framework.

IFSRA noted that two opportunities arise for the industry to submit their views on the regulatory structure – one in relation to the consultation exercise regarding transparency & remuneration (deadline 30th March) and the other in relation to codes of conduct (deadline 14th April).

A detailed evaluation of the merits or otherwise of each of these issues is outside the scope of this study but we would recommend that the Pension Board in association with other interests undertake a detailed review of regulation to ensure that there is sufficient consumer protection and that regulatory requirements do not unnecessarily hinder pension take up. Some of our proposals, however, will address the issue of making it easier for individuals to claim the tax relief by providing tax credits or exemptions for tax directly to the pension providers. We would also point out that available research suggests that regulation may be a less important barrier to increasing pension coverage than the other factors identified.

Industry Action to Increase Consumer Understanding and Improved Marketing

An important barrier to take up of pensions is consumers assessment of the complexity of pension products and the difficulties in understanding the nature of the product offering.

This has important implications for the sector and enhanced industry action is needed to increase consumer understanding, simplify products and improve the marketing of pensions. Recent improvements in the performance of pension funds reflecting their weighting on equities and the improvements in equity markets should also assist in pension take up. Indecon however accepts that there are constraints on the pension industry arising from the regulatory environment.

INCENTIVES FOR EMPLOYERS INVESTMENT IN PENSIONS

We believe that ways to incentivise employers to invest in pensions should be an important element of any medium term plan to enhance pension coverage. This could include ways to ease administrative and financial costs particularly on SMEs. Within this restricted assignment it has not been feasible for Indecon to develop cost effective targeted proposals on this area but we support a more detailed review of this issue.

Recommendations

Based on the detailed analysis undertaken by the consultancy team and taking account of our assessment of the real barriers to pensions take up and the need to ensure that any new incentives are equitable and cost effective we have recommended a number of new initiatives as outlined in the table below.

Table 7.15: Proposed Recommendations

■ Once-off increase in pension contribution limits for individuals with underutilised contributions over past three years
■ Exempt 23% exit tax on capital gains on SSIA accounts upon transfer to pension fund providing no income tax relief is obtained on this amount
■ Pensions related tax credit providing no income tax relief is obtained
■ Family income support tax credit uplift for pension contributions
■ Detailed review of regulatory framework for PRSAs
■ Industry action to increase consumer understanding and improved marketing
■ Review of Incentives for SME Involvement in Pensions.

Source: Indecon

We believe these recommendations would assist in increasing pension take up and would address equity, effectiveness and deadweight concerns. The proposed additional incentives represent a package of new targeted initiatives which are focused on those groups with no or inadequate pension provisions. They would also assist the sector in marketing pension options to SSIA account holders and therefore reduce the inflationary impact of SSIA fund expenditures.

ANNEX 1

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ANNEX 2

Additional Data on Characteristics of Persons Who 'Save'

Table A2.1: Characteristics of Persons Who 'Save'

■ Tend to be:
■ Male;
■ Somewhat older;
■ Higher social class.
■ More likely to be married, working full-time and finished education at third level.
■ They believe that regular saving is the best way to save and like to put money aside for any day. They like the idea of saving but still feel they could save more if they tried.
■ They feel it is getting easier to pay bills and that they have money aside at the end of the month.
■ They are quite savvy when it comes to pensions.
■ They believe that company pension schemes are good, when you save for pension you get tax relief and companies are cutting back on pensions.

Source: Lansdowne Market Research Undertaken for the Irish Insurance Federation.

Table A2.2: Characteristics of Persons Who 'Can't Save'

■ Tend to be:
■ Female;
■ Lower social class;
■ Either very old or very young.
■ They are more likely to be married and either working part time or not working, and finished education at primary level.
■ They acknowledge that they can barely make ends meet and that they should manage their money carefully.
■ It is not getting easier for them to pay their bills. They generally do not have something left at the end of the month. They worry about money and could not save more even if they tried.
■ They disagree that insurance companies give a good return when you invest with them, and that they should save more for their pension. At the same time, they are aware that they will not survive on less when they retire.

Source: Lansdowne Market Research Undertaken for the Irish Insurance Federation.

Table A2.3: Characteristics of Persons Who 'Intend to Save'

■ More likely to be:
■ Female;
■ 25-44;
■ Farmers.
■ They are more likely to be married and housewives.
■ They do like to put money aside for a rainy day but also feel that they should save more for their pension.
■ They tend to disagree that they do not have to worry about money anymore.

Source: Lansdowne Market Research Undertaken for the Irish Insurance Federation.

ANNEX 3**Trends in Payments to Special Savings Incentive Scheme – 2001 to 2004****Table A3.1: Monthly Revenue Cashflow Figures Relating to the Special Savings Incentive Scheme - 2001**

Claims for month	Subscriptions in month/ year - €m	Tax Credit in respect of month/year - €m	Tax Credit Payout in month/year (i.e. Exchequer Cost) - €m
May	7.8	2.0	/
June	24.6	6.1	2.0
July	36.7	9.1	6.1
August	44.0	11.0	9.1
September	50.4	12.6	11.0
October	57.2	14.2	12.6
November	64.4	16.0	14.2
December	71.5	17.8	16.0
Total	356.6	88.8	71.0

Source: Department of Finance.

Table A3.2: Monthly Revenue Cashflow Figures Relating to the Special Savings Incentive Scheme - 2002

Claims for month	Subscriptions in month/ year - €m	Tax Credit in respect of month/year - €m	Tax Credit Payout in month/year (i.e. Exchequer Cost) - €m
January	78.0	19.3	17.8
February	85.8	21.3	19.3
March	102.1	25.3	21
April	173.5	43.1	25.6
May	178.6	44.4	43.1
June	175.1	43.5	44.4
July	178.3	44.1	43.5
August	176.3	43.6	44.1
September	176.8	43.6	43.6
October	175.5	43.5	43.6
November	177.3	43.5	43.5
December	181.0	44.4	43.5
Total	1,859.30	459.6	433.0

Source: Department of Finance.

Table A3.3: Monthly Revenue Cashflow Figures Relating to the Special Savings Incentive Scheme - 2003

Claims for month	Subscriptions in month/ year - €m	Tax Credit in respect of month/year - €m	Tax Credit Payout in month/year (i.e. Exchequer Cost) - €m
January	184.3	44.9	44.4
February	180.1	44.1	44.8
March	181.9	44.0	44.2
April	181.5	44.2	44.0
May	181.6	44.0	44.2
June	181.8	44.3	44.0
July	182.4	44.3	44.3
August	181.2	44.1	44.3
September	183.7	44.9	44.1
October	183	44.7	44.9
November	181.8	44.3	44.8
December	183.8	44.9	44.0
Total	2187.1	532.7	532

Source: Department of Finance.

Table A3.4: Monthly Revenue Cashflow Figures Relating to the Special Savings Incentive Scheme - 2004

Claims for month	Subscriptions in month/ year - €m	Tax Credit in respect of month/year - €m	Tax Credit Payout in month/year (i.e. Exchequer Cost) - €m
January	185.4	45	45.2
February	182.6	44.1	44.8
March	188.4	45.7	44.2
April	187.1	45.3	45.6
May	187.6	45.5	45.1
June	188.6	45.7	45.8
July	188.1	45.7	46
August	189.7	46.2	45.3
September	190.1	46.3	46.3
October	190.6	46.4	46.3
November	Na	Na	Na
December	Na	Na	Na
Total	1878.2	455.9	501

Source: Department of Finance.

ANNEX 4**Additional Survey Data****Table A4.1: Ownership of Financial Products**

Financial Product	Yes	No
Occupation Pension, PRSA or Other Personal Pension	45%	55%
SSIA Account	41%	59%

Source: Indecon commissioned TNS mrbi survey.

Table A4.2: Are the following potential barriers to increasing the coverage of pensions in Ireland significant or not significant?

Potential Barriers	Significant	Not Significant
Complexity of pension products	57%	43%
Regulation of sale of pensions	49%	51%
Taxation treatment of pensions	54%	46%
Consumer understanding of pensions	59%	41%
Affordability of pensions	64%	36%

Source: Indecon commissioned TNS mrbi survey.

Table A4.3: Does “complexity of pension products” represent a barrier to increasing the coverage of pensions in Ireland? – Responses by age category

Age	Significant	Not Significant
15 - 19	52%	48%
20 - 24	59%	41%
25 – 34	66%	34%
35 – 44	59%	41%
45 – 54	59%	41%
55 – 64	54%	46%
65+	44%	56%
Total	57%	43%

Source: Indecon commissioned TNS mrbi survey.

Table A4.4: Does “complexity of pensions products” represent a barrier to increasing the coverage of pensions in Ireland? – Responses by social class

Social Class	Significant	Not Significant
AB	64%	36%
C1	60%	40%
C2	65%	35%
DE	50%	50%
F	43%	57%
Total	57%	43%

Source: Indecon commissioned TNS mrbi survey.

Table A4.5: Does the “regulation of sale of pensions” represent a barrier to increasing the coverage of pensions in Ireland? – Responses by age category

Age	Significant	Not Significant
15 - 19	54%	46%
20 - 24	52%	48%
25 – 34	54%	46%
35 – 44	48%	52%
45 – 54	49%	51%
55 – 64	44%	56%
65+	40%	60%
Total	49%	51%

Source: Indecon commissioned TNS mrbi survey.

Table A4.6 Does the “regulation of sale of pensions” represent a barrier to increasing the coverage of pensions in Ireland? – Responses by social class

Social Class	Significant	Not Significant
AB	64%	36%
C1	50%	50%
C2	53%	47%
DE	43%	57%
F	40%	60%
Total	49%	51%

Source: Indecon commissioned TNS mrbi survey.

Table A4.7: Does the “taxation treatment of pensions” represent a barrier to increasing the coverage of pensions in Ireland? – Responses by age category

Age	Significant	Not Significant
15 - 19	58%	42%
20 – 24	53%	47%
25 – 34	60%	40%
35 – 44	58%	42%
45 – 54	50%	50%
55 – 64	56%	44%
65+	44%	56%
Total	54%	46%

Source: Indecon commissioned TNS mrbi survey.

Table A4.8: Does the “taxation treatment of pensions” represent a barrier to increasing the coverage of pensions in Ireland? – Responses by social class

Social Class	Significant	Not Significant
AB	66%	34%
C1	60%	40%
C2	59%	41%
DE	44%	56%
F	44%	56%
Total	54%	46%

Source: Indecon commissioned TNS mrbi survey.

Table A4.9: Does “consumer understanding of pensions” represent a barrier to increasing the coverage of pensions in Ireland? – Responses by age category

Age	Significant	Not Significant
15 - 19	53%	47%
20 - 24	64%	36%
25 – 34	68%	32%
35 – 44	66%	34%
45 – 54	59%	41%
55 – 64	54%	46%
65+	46%	54%
Total	59%	41%

Source: Indecon commissioned TNS mrbi survey.

Table A4.10: Does “consumer understanding of pensions” represent a barrier to increasing the coverage of pensions in Ireland? – Responses by social class

Social Class	Significant	Not Significant
AB	67%	33%
C1	68%	32%
C2	63%	37%
DE	52%	48%
F	42%	58%
Total	59%	41%

Source: Indecon commissioned TNS mrbi survey.

Table A4.11: Does “affordability of pensions” represent a barrier to increasing the coverage of pensions in Ireland? – Responses by age category

Age	Significant	Not Significant
15 – 19	66%	34%
20 – 24	64%	36%
25 – 34	68%	32%
35 – 44	70%	30%
45 – 54	66%	34%
55 – 64	59%	41%
65+	54%	46%
Total	64%	36%

Source: Indecon commissioned TNS mrbi survey.

Table A4.12: Does “affordability of pensions” represent a barrier to increasing the coverage of pensions in Ireland? – Responses by social class

Social Class	Significant	Not Significant
AB	70%	30%
C1	70%	30%
C2	69%	31%
DE	58%	42%
F	54%	46%
Total	64%	36%

Source: Indecon commissioned TNS mrbi survey.

Table A4.13: Likely Impact of Enhanced Tax Allowances

Impact	Yes	No
Result in you taking out a pension when you would otherwise not have purchased one?	66%	34%
Result in you taking out a larger pension than you would otherwise have purchased?	59%	41%
Have no impact?	33%	67%

Source: Indecon commissioned TNS mrbi survey.

Table A4.14: Would enhanced tax allowances result in you taking out a pension when you would otherwise not have purchased one? – Responses by age category

Age	Yes	No
15 – 19	66%	34%
20 – 24	75%	25%
25 – 34	80%	20%
35 – 44	67%	33%
45 – 54	70%	30%
55 – 64	58%	42%
65+	39%	61%
Total	66%	34%

Source: Indecon commissioned TNS mrbi survey.

Table A4.15: Would enhanced tax allowances result in you taking out a pension when you would otherwise not have purchased one? – Responses by social class

Social Class	Yes	No
AB	73%	27%
C1	68%	32%
C2	72%	28%
DE	58%	42%
F	62%	38%
Total	66%	34%

Source: Indecon commissioned TNS mrbi survey.

Table A4.16: Would enhanced tax allowances result in you taking out a larger pension? – Responses by age category

Age	Yes	No
15 – 19	57%	43%
20 – 24	69%	31%
25 – 34	64%	36%
35 – 44	66%	34%
45 – 54	65%	35%
55 – 64	52%	48%
65+	39%	61%
Total	59%	41%

Source: Indecon commissioned TNS mrbi survey.

Table A4.17: Would enhanced tax allowances result in you taking out a larger pension?
– Responses by social class

Social Class	Yes	No
AB	67%	33%
C1	63%	37%
C2	60%	40%
DE	51%	49%
F	63%	37%
Total	59%	41%

Source: Indecon commissioned TNS mrbi survey.

Table A4.18: Would enhanced tax allowances have no impact? – Responses by age category

Age	Yes	No
15 – 19	29%	71%
20 – 24	30%	70%
25 – 34	33%	67%
35 – 44	32%	68%
45 – 54	31%	69%
55 – 64	44%	56%
65+	36%	64%
Total	33%	67%

Source: Indecon commissioned TNS mrbi survey.

Table A4.19: Would enhanced tax allowances have no impact? – Responses by social class

Social Class	Yes	No
AB	30%	70%
C1	35%	65%
C2	34%	66%
DE	33%	67%
F	34%	66%
Total	33%	67%

Source: Indecon commissioned TNS mrbi survey.

Table A4.20: Impact of Allowing Transfers of SSIA Monies Into Pensions

Impact	Yes	No
Result in you taking out a pension when you would otherwise not have purchased one?	54%	46%
Result in you taking out a larger pension than you would otherwise have purchased?	48%	52%
Have no impact?	34%	66%

Source: Indecon commissioned TNS mrbi survey.

Table A4.21: Would allowing transfers of SSIA monies into pensions result in you taking out a pension when you would otherwise not have purchased one? Responses by age category

Age	Yes	No
15 – 19	57%	43%
20 – 24	66%	34%
25 – 34	54%	46%
35 – 44	60%	40%
45 – 54	65%	35%
55 – 64	47%	53%
65+	25%	75%
Total	54%	46%

Source: Indecon commissioned TNS mrbi survey.

Table A4.22: Would allowing transfers of SSIA monies into pensions result in you taking out a pension when you would otherwise not have purchased one? Responses by social class

Social Class	Yes	No
AB	67%	33%
C1	57%	43%
C2	55%	45%
DE	48%	52%
F	44%	56%
Total	54%	46%

Source: Indecon commissioned TNS mrbi survey.

Table A4.23: Would allowing transfers of SSIA monies into pensions result in you taking out a larger pension? Responses by age category

Age	Yes	No
15 – 19	50%	50%
20 – 24	51%	49%
25 – 34	48%	52%
35 – 44	53%	47%
45 – 54	58%	42%
55 – 64	43%	57%
65+	25%	75%
Total	48%	52%

Source: Indecon commissioned TNS mrbi survey.

Table A4.24: Would allowing transfers of SSIA monies into pensions result in you taking out a larger pension?
Responses by social class

Social Class	Yes	No
AB	58%	42%
C1	53%	47%
C2	50%	50%
DE	39%	61%
F	40%	60%
Total	48%	52%

Source: Indecon commissioned TNS mrbi survey.

Table A4.25: Would allowing transfers of SSIA monies into pensions have no impact?
Responses by age category

Age	Yes	No
15 – 19	33%	67%
20 – 24	32%	68%
25 – 34	38%	62%
35 – 44	38%	62%
45 – 54	27%	73%
55 – 64	38%	62%
65+	32%	68%
Total	34%	66%

Source: Indecon commissioned TNS mrbi survey.

Table A4.26: Would allowing transfers of SSIA monies into pensions have no impact?
Responses by social class

Social Class	Yes	No
AB	33%	67%
C1	33%	67%
C2	35%	65%
DE	36%	64%
F	30%	70%
Total	34%	66%

Source: Indecon commissioned TNS mrbi survey.

