Supporting Pension Contributions Through the Tax System: Outcomes, Costs and Examining Reform

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Introduction

In recent years there has been a move in many OECD countries towards an increased role for private-provided pensions and a reduction in the importance of state-provided pensions. The more common defined benefit (DB) pension schemes are being replaced by different kinds of defined contribution (DC) schemes. These DC schemes come with an attendant transfer of risk and responsibility to individuals. These recent developments highlight the growing importance of personal contributions to pension schemes and the need for successful policy initiatives to generate them.

In the public policy arena, there has been a concerted drive to utilise the taxation system to encourage retirement savings. These international trends are also evident in Ireland which is an interesting case study given its younger demographic profile. This demographic profile has the potential to introduce specific policy initiatives that could address some of the pension provision problems associated with an ageing society.

There have been additional policy initiatives aimed at highlighting the importance of the benefits of personal pension contributions together with reforms for determining pension eligibility and social security pensions. It should be highlighted that supporting private pension savings is an expensive element of the taxation system. In terms of revenue foregone, pension-related tax expenditures cost the equivalent of 4.8 per cent of total annual taxation and social insurance revenue.[1] The level of this support raises questions about its efficacy and sustainability. Recently the OECD highlighted that a clear objective for policy makers should be to ensure "that pensions systems provide adequate retirement incomes to all workers" (OECD, 2015: 10). Consequently, it is a matter of considerable concern how these resources are targeted.

Data

The analysis in this paper uses microdata from the 2014 Central Statistics Office (CSO) Survey on Income and Living Conditions (SILC). This survey is part of an annual Europe wide household survey and collects income and living standards information from a representative national sample. The data contained responses from 14,078 individuals in 5,486 households. It should be noted that such survey data sources are prone to some problems. Income surveys often experience lower response rates from high income households. Likewise, successful sampling can be difficult to achieve among low-income households and minorities while those in institutions are excluded from the sample. In an effort to ensure accuracy the collected income data are reconciled by the CSO with administrative tax and welfare records.

In order to determine the tax relief received by individuals, and to simulate alternative structures for these taxation supports, Collins and Hughes developed a microsimulation model of the Irish taxation system. It was built using the 2014 SILC data and the variables on household and individual income as well as welfare entitlements. The SILC data does not indicate whether those in the survey are assessed as an individual or couple for tax purposes. Income tax rules allow married couples to be jointly assessed as one tax unit and jointly share many of the tax credits and tax bands that would otherwise apply to two single units. Based on SILC information on household composition, marital status and the income of couples, the Collins-Hughes model simulates the tax status (individually assessed or jointly assessed) of each individual. This model follows the approach of the Revenue Commissioners which aims to determine the most tax favourable outcome for individuals.

[1] In 2013, the latest year for which full tax expenditure data are available, the revenue forgone cost of tax expenditures associated with private pensions was estimated by the Revenue Commissioners (2016) as €2.4 billion. The total taxation and social insurance collected in that year was €50 billion.

Overall the paper offers a comprehensive analysis of all tax expenditure associated with tax supported contributions from both individuals (employees and otherwise) and employers. It considers the distributive profile of tax-based pension supports. Through their newly developed model Collins and Hughes simulate the first-round effects of changes to the structure of tax reliefs and pension contribution limits.

Results

The results of the analysis are divided into three sections. *First*, the value and distribution of tax supported pension contributions are discussed. The analysis highlights the relatively small size of most pension contributions (both nominally and as a proportion of earnings). This raises questions around the effectiveness of policies aimed at getting people to save for their retirement. Most contributions are likely to be inadequate to guarantee sufficient income replacement rates after retirement. Inherent in this result are the implications for the state when individuals are more likely to draw on costly state benefit programmes in retirement (Mirrlees Review, 2011: 476).

Second, how the tax relief associated with these contributions is distributed across income earners and the overall income distribution is examined. Using microsimulation on the distribution of pension contributors (employer, employee and individual contributions) by marginal tax rate (the Irish system comprises a standard and higher income tax rate) it finds among those at the standard income tax rate the median contribution is €939 per annum. Among pension contributors at the higher tax rate, the median contribution is more than two-and-a-half time this annual amount at €2,536.

Finally, Collins and Hughes consider the revenue and distributive implications of some reforms to the current system. For the most part research and policy proposals have highlighted the large recurring costs of their continuance, and the potential to raise and use additional taxation revenue from this area. These views have been countered by pension industry representatives, in particular suggesting that the current system assists middle income earners to maintain their living standards in retirement (Society of Actuaries in Ireland, 2012). The final part of the analysis reports the results from the simulation of a number of alternative policy options, in particular assessing their distributive and cost implications. The results of this analysis are summarised in *Table 8*.

The focus on employee and individual contributions reflects the policy approaches in this area which have tended to assume that it is possible to alter these contribution mechanisms rather than those from employers. Overall the simulations highlight some possibility for state savings and equity improvements. However, these policy options do not address the underlying problem that, for most, pension participants' contributions remain small. For most other earners outside the public sector there are few contributions to occupational pensions where employers and/or employees contribute to a pension fund which pays out a pension, generally earnings-related, upon retirement. Similarly, contributions are small for voluntary private pensions where individuals contribute to their own pension fund.

Conclusions

This paper adds to the existing literature in two ways. First, it provides a new insight into the scale and adequacy of pension contributions derived from all sources in the Irish context: from employees and employers to occupational pensions and individuals into private pensions. Adding employer contributions provides both a more complete picture and a more thorough base on which to determine the adequacy of pension contributions. Second, this analysis provides an informed update of the cost and distributive profile of tax expenditure in the Irish taxation system. As Morel et al. (2016:3) note this distributive profile of social tax expenditure is frequently overlooked. Collins and Hughes have addressed this gap in the research literature.

References

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