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Imagining the Ideal Pension System

International Perspectives

Dana M. Muir
John A. Turner
Editors

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Public and Private Provision of Pensions and the Ideal Pension System for Ireland

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Pension systems in many countries are far from ideal in terms of equity, efficiency, and viability. Pension reform has moved to center stage in most developed economies, but it is important to recognize that pension reform may not always result in improvement in pension payments or security.[1] Many would dispute the statement in the EU Green Paper on pensions that, "Reforms have underpinned recent increases in effective retirement ages and opened new avenues to delivering adequate incomes in a sustainable manner" (European Commission 2010, p. 5). As shown later, retired persons in Ireland are very dependent on state social security payments. Yet the EU Green Paper assumes "public replacement rates will decline" and that "it is important to provide sufficient opportunities for complementary entitlements" (European Commission 2010, p. 8).

Pension systems need reform, but change is costly for all stakeholders, and hence pension systems have considerable path dependency. Reform that leads to the introduction of new sources of pension income leads to the issue of how the new pension arrangements will be integrated with existing pension arrangements. If there is replacement, there may be considerable administrative costs. A new type of pension arrangement, such as an individual pension, is often introduced in addition to existing arrangements. This has happened in many EU countries (see Stewart and Hughes 2009) and leads to considerable inefficiencies resulting from multiple sources of income, often of relatively small amounts.

Pension systems and government proposals for pension reform are driven by tax relief that disproportionately benefits those with higher incomes. But the main failure is the low level of income given to those in retirement. Although the Irish pension system needs reform, after several reviews and a government Green Paper, proposals for reform remain inadequate in a number of respects.

IDENTIFYING PENSION REFORM ISSUES

Reform must be evidence based, yet there are large data gaps in relation to pension systems and the income and assets of retired persons. This is especially true of the Irish pension system. Three particular data gaps stand out:

1) Despite the enormous cost of tax relief, it is not known whether the relief increases net resources for retirement.
2) Few data are available on the incomes and assets of retired persons. We may surmise that the collapse of bank shares (the "blue chips") has disproportionately affected a certain section of retired persons, but the extent to which this has happened is not known.
3) Despite the encouragement and tax incentives to join funded pension systems, there are no data on the costs in terms of administrative and other charges of running such plans. Instead a government Green Paper on pension reform (Department of Social and Family Affairs 2007a) relied on data from the UK pension system—a very different pension system because of its considerable economies of scale resulting from its larger size. One may surmise that administrative costs are higher in Ireland. The Green Paper refers to a "typical charge" of 1.5 percent per year, but no evidence is offered to support this rate. Indeed, administrative and other charges are a key aspect of pension systems, but they are often ignored. Returns are nearly always given gross of costs, so that a gross return of 4.5 percent becomes a net 3.0 percent after costs. Over time this can have a dramatic effect on accumulating lump sums.

Perhaps the most important data issue is that projections, often for a 40-year period, are treated as facts. One prominent example is that the proportion of those aged 65 and over has been projected to increase, but the age structure of the population and crucially the size of the labor force is uncertain. The only certainty is that past demographic projections for Ireland have been wrong. A second example is that financial market returns are assumed to be constant. The dot com bubble and the recent crash were not forecast—they were assumed to be impossible. This issue is compounded by the false belief that equities will always outperform any other form of investment—that is, there is a positive equity risk premium (Stewart 2011, Table 3). The projected illustrated returns on the proposed auto-enrollment arrangement in the National Pensions Framework document are 7 percent per year real return over a 40-year period (Department of Social and Family Affairs 2010, Table 4.1). This is an important assumption and is crucial to the proposed new pension plan. In contrast, the average return on group-managed pension funds for the 10-year period to April 2010 was 0.5 percent. The latest group-managed pension fund returns are an improvement compared with previous years.

Proposals for an ideal pension system should show how it will solve the problems of the existing system in relation to simplicity, adequacy, cost, equity, coverage, and effectiveness in delivering pensions. We will show how Ireland's current pension system fails to meet many of these criteria and how an ideal system would enable all of them to be met.

THE CONTEXT FOR REFORM

Ireland has a population of about 4 million (see Table 4.1). Home ownership rates are high, with 80 percent of all households and 90 percent of pensioner households owning their own homes. Life expectancy for men and women at age 65 is 15.4 years and 18.7 years, respectively.

Although Ireland is committed to maintaining living standards in old age, the balance, in terms of policy, between public and private provision is struck in favor of private provision. Successive governments have taken the view that the role of the public social security pension

Table 4.1 Key Economic and Demographic Data for Ireland, 2006

Category	
Population (million)	4.2
GDP current prices and current PPPs[a], (US$, billion)	175.1
GDP per capita, current prices and PPPs (US$)	41,300
Home ownership rates: all households (%)	80
Home ownership rates: households aged 65+ (%)	90
Life expectancy in 2001 at age 65: male (years)	15.4
female (years)	18.7

[a] Purchasing power parity.

SOURCE: GDP and GDP per capita: OECD in Figures; home ownership: Department of Social and Family Affairs (2007b, p. 26); life expectancy: Irish Life Table No. 14, 2001–2003.

system is to provide a minimum basic income that will prevent poverty in retirement. As the state social security pension is not sufficient for most people to maintain their living standard in retirement, the private sector pensions market is given generous tax relief on contributions and investment income to encourage individuals to make their own arrangements to top up the flat-rate state pension with an earnings-related supplement from a private pension provider.

The Pension System in Ireland

The structure of the pension system in Ireland reflects successive governments' conceptions about the role of the state. Table 4.2 shows that the structure of the Irish pension system is relatively simple. It is based on a partnership approach between government, employers, and employees. It consists of a compulsory state social insurance system (social security), which levies contributions at a range of proportional rates for different classes of contributors and pays flat-rate benefits, and a voluntary private system, which is subsidized through the tax system. The social insurance system provides a state pension (transition) at age 65 that requires withdrawal from the labor force for one year and a state pension (contributory) at age 66 that does not require withdrawal from the labor force. In addition, a means-tested state pension (non-contributory) is provided for those not covered by the social security system. The amounts paid by the transition and contributory pensions

Table 4.2 Structure of Ireland's Pension System

First tier: Mandatory public pension system—flat-rate social welfare pensions	
Social insurance (employees)	Social assistance (not in workforce or not qualifying for social insurance)
Age 65: state pension (transition)	
Age 66: state pension (contributory)	Age 66: state pension (non-contributory)
Second tier: Voluntary private pension system—occupational and personal pensions	
Occupational (employees)	Personal (self-employed and employees)
Defined benefit	Retirement Annuity Contract (RAC)
Defined contribution	Personal Retirement Savings Account (PRSA)

SOURCE: Department of Social and Family Affairs, http://www.dsfa.ie.

are the same, while the non-contributory pension has usually been about 10 percent less than the social security pension, although the difference is currently just 5 percent. For convenience, these three pensions will be referred to as the social welfare pension where it is not necessary to distinguish among them.

An important feature of the Irish pension system is that the state social security pension is integrated with occupational pension payments for most defined benefit plans, so that both payments combined cannot exceed an agreed replacement rate. This means that an increase in state social security pensions may reduce payments from occupational pension plans. For this reason, employers with defined benefit plans welcome increases in social welfare payments.

The private pension system has two components: occupational pension plans and personal pension plans. Occupational plans are provided on a voluntary basis by employers for groups of employees. Personal pension plans are for employees who are not covered by an occupational plan or individuals who are not employed. Personal plans take the form of Retirement Annuity Contracts (RAC) for the self-employed and Personal Retirement Savings Accounts (PRSA) for everyone else.

In the past, most of the workplace plans were defined benefit pensions. Consequently, they were supposed to provide a guaranteed

benefit that would replace up to two-thirds of preretirement earnings for employees who spent their full career with one employer. In the last 10 years or so, many defined benefit pension plans have been closed to new entrants. They have been replaced by defined contribution plans because most employers are no longer willing to guarantee new entrants to the labor force a pension related to length of service and level of final earnings. The benefits that a member of an occupational or individual defined contribution plan can expect will depend on how much is contributed to the plan, how well the plan is managed, and the performance of stocks, shares, and other assets. All of the investment risk in defined contribution plans is borne by employees or the self-employed rather than by employers.

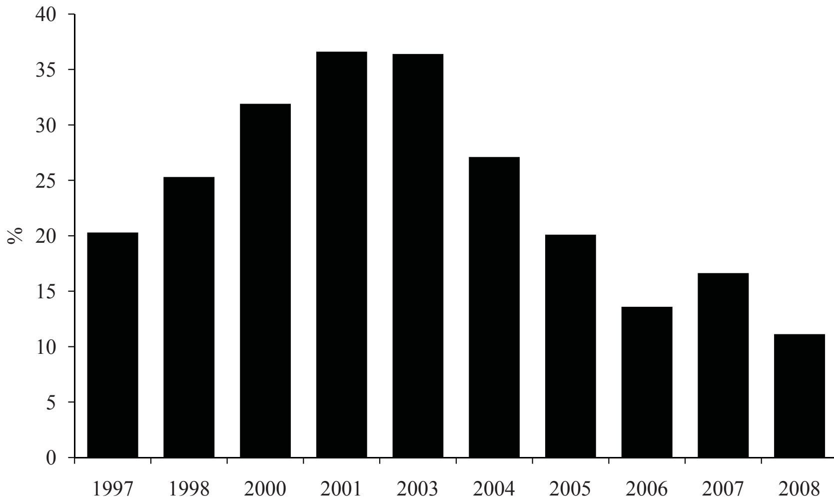
Although the structure of the pension system is relatively simple, operating it has become complex because of the variety of categories of workers contributing to the public social security system and the large buildup of pension and tax law required to regulate private pension funds and the drawdown of pension benefits.

Pensioner Poverty Rates and the Level of State Social Security Pensions

Considerable progress has been made in recent years in reducing poverty among pensioners by increasing the social welfare pension, where poverty is defined as a retirement income of below 60 percent of average earnings. Figure 4.1 shows that the percentage of pensioners at risk of poverty increased from 20 percent in 1997 to over 36 percent in 2003, primarily due to the failure of the social welfare pension to keep pace with increases in average industrial earnings during a period of rapid earnings growth. Since then, however, the social welfare pension has increased faster than workers' earnings and the rate fell to just over 11 percent in 2008.[2]

The increases in the social welfare pension in 2004 and subsequent years have significantly improved Ireland's ranking in international comparisons of pensioner poverty. Using a comparable measure of relative income poverty for all EU27 countries, Figure 4.2 shows that Ireland's pensioner poverty rate of 21 percent in 2008 was a little over the average EU27 rate of 19 percent.[3] Nevertheless, the fact that one-fifth of pensioners were at risk of poverty in 2008 indicates that there

Figure 4.1 Percentage of People Age 65 and Over in Ireland at Risk of Poverty Relative to the 60 Percent Poverty Line, 1987–2008



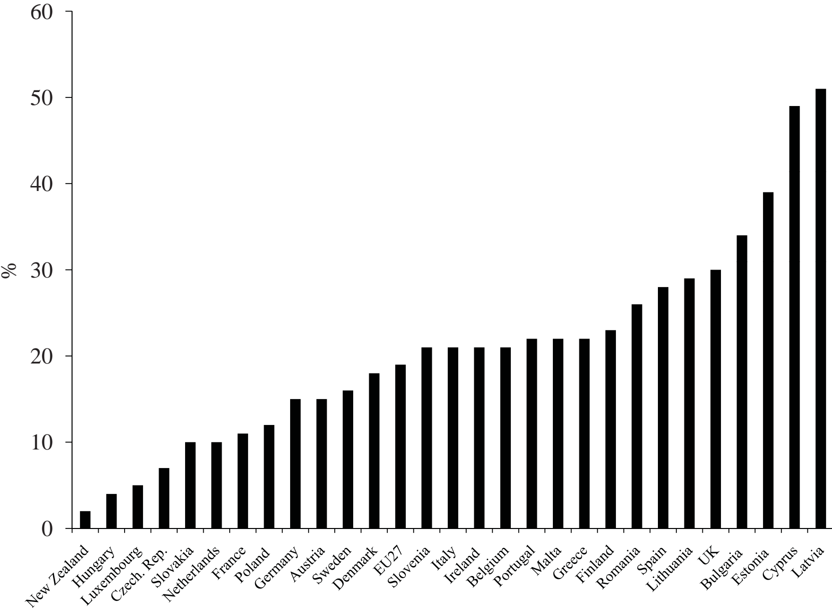
SOURCE: Whelan et al. (2003) and Central Statistics Office (2009).

is some way to go to eliminate pensioner poverty in Ireland. The very low pensioner poverty rate for New Zealand, which has a flat-rate state social security pension similar to the social welfare pension in Ireland, indicates what could be achieved if Ireland were prepared to increase the level of the social welfare pension above the poverty level.

Some progress has been made toward this objective. Figure 4.3 shows that the level of the social security and social assistance pensions for couples relative to average industrial earnings changed little between 1994 and 2000. In 2001, the government began to respond to the large increase in pensioner poverty that had occurred when the economy was booming during the 1997–2000 period by starting to increase pensions faster than earnings. This policy resulted in the gap between social security and social assistance pensions and the 60 percent poverty line for a couple narrowing from about 6 and 10 percentage points, respectively, in 2003 to 4 and 7 percentage points in 2008.

These improvements have, therefore, brought the social security and social assistance pensions to within striking distance of the poverty line of 60 percent of average earnings. It would be perfectly feasible for the Irish government to increase the social welfare pension to a level

Figure 4.2 Percentage of People Age 65 and Over at Risk of Poverty Relative to the 60 Percent Poverty Line for People Age 65 and Over in the EU27 in 2008 and New Zealand in 2009

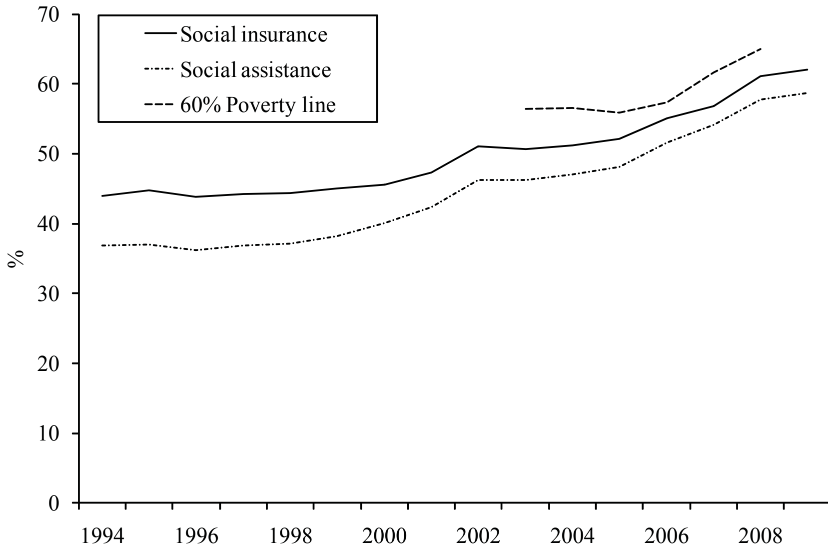


SOURCE: Zaidi (2010) and Ministry of Social Development (2005).

that would virtually eliminate pensioner poverty, as has been done in New Zealand with a similar flat-rate state pension. Callan, Nolan, and Walsh (2007) have shown that an increase in the social welfare pension to bring it above the poverty level would require only 837 ($1,071) million euros (€) of the €1,462 ($1,871) million increase in revenue the Exchequer (government treasury department) could raise by giving tax relief on private pension contributions at the standard rate of tax rather than at the marginal rate of tax.[4]

On its own, increasing the social welfare pension would not resolve the complications resulting from incomplete contribution records for the social security pension, the means test for the social assistance pension, rules about dependency, the retirement condition required for the social security state pension (transition), and the interaction of the social welfare pension with private pensions, which creates uncertainty about

Figure 4.3 Social Insurance, Social Assistance Pension, and the 60 Percent Poverty Line for a Couple Relative to Average Industrial Earnings, 1994–2010

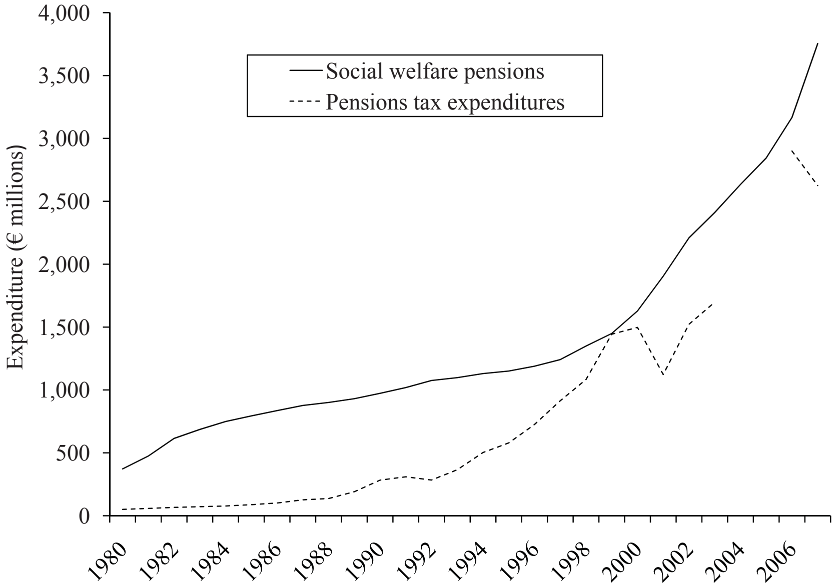


how much to save and results in the loss of private pension benefits for low-paid members of some occupational defined benefit pension plans.

Women in Ireland are particularly disadvantaged by the social security and private pension systems because women provide most of the care required by children and elderly relatives. Consequently, their work histories are more irregular than those of men, and it is more difficult for women to qualify for either a social welfare or a private pension. As the purpose of Ireland's flat-rate social welfare pension is to prevent poverty in old age, these problems could ideally be addressed by introducing a universal state social security pension to eliminate the means test and differential payments to pensioners whose needs are the same.

The introduction of a universal pension would require an increase in public expenditure. This is the primary reason why a universal state social security pension was ruled out in the Green Paper on Pensions (Department of Social and Family Affairs 2007a). However, as already noted, there is some scope for increasing current expenditure on pensions because Ireland has operated a very favorable tax regime for

Figure 4.4 Actual Expenditures on Social Welfare Pensions and Tax Expenditures on Pensions, 1980–2007

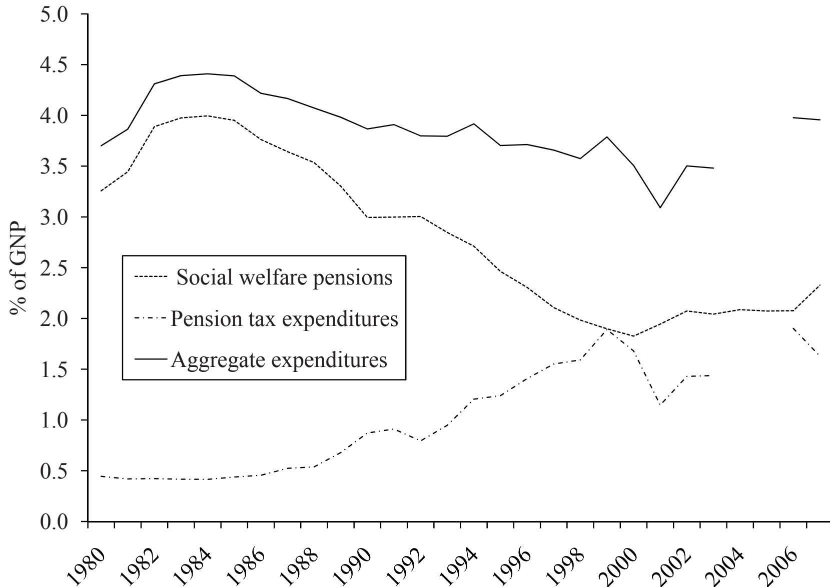


NOTE: There is a break in the tax expenditure series in 2004 and 2005, and the figures for 2006 and 2007 are not comparable with those for previous years because of a change in the method of estimation.
SOURCE: Social welfare pensions: Hughes (1985, Table A4) and Statistical Reports of the Department of Social and Family Affairs. Pensions tax expenditure: Statistical Reports of the Revenue Commissioners.

pensions to encourage the development of the private pension system. Figure 4.4 indicates that the cost of tax relief was initially fairly modest, but it has grown rapidly over the last three decades. As argued later, reducing tax relief would enable the payment of higher social welfare pensions.

In 1980, the earliest year for which the Revenue Commissioners estimated the cost of the tax relief for occupational pensions, it amounted to about €51 ($64) million. By 1990, its cost had increased more than five times to €283 ($362) million. In the year 2000, just before the dot com bubble burst, the Exchequer was forgoing about the same amount in tax revenue, €1.5 ($1.92) billion, as it was spending on state social

Figure 4.5 Exchequer Expenditures on Social Welfare Pensions, Pension Tax Relief, and the Aggregate for Both, 1980–2007 (as a percentage of GNP)



NOTE: There is a break in the tax expenditure series in 2004 and 2005, and the figures for 2006 and 2007 are not comparable with those for previous years because of a change in the method of estimation.

SOURCE: Annual Statistical Reports of the Department of Social and Family Affairs and the Revenue Commissioners.

security pensions, €1.6 ($2.05) billion, for those aged 65 and over. In the Finance Act of 2004, steps were taken to improve the quality of data on pension contributions by requiring employers to provide details in their annual P35 tax return form of aggregate employer and employee contributions to pension plans. When the results of the new method of estimation were published in the Green Paper on Pensions (Department of Social and Family Affairs 2007a), they showed that the cost of tax relief for private pensions was significantly higher than had been shown by previous estimates. In 2006, the cost of the tax relief amounted to €2.9 ($3.7) billion—almost the same as the amount the Exchequer spent, €3.2 ($4.1) billion, on state pensions for older people. In 2007,

the cost of the tax relief fell to €2.6 ($3.3) billion as a consequence of the financial crisis, while the cost of state social security pensions increased to €3.9 ($5.0) billion.

If the cost of tax forgone on private pensions is taken into account, we get a different perspective on pension costs. Figure 4.5 shows the cost of public expenditure and tax expenditure on pensions in Ireland relative to GNP over the period 1980–2007. At the beginning of the period in 1980, the cost of the state social security pension was 3.3 percent of GNP, while the cost of the pension tax expenditure was 0.4 percent of GNP. The cost of the social security pension increased to 4 percent of GNP up to 1985, while the cost of the pension tax expenditure remained around one-tenth of that at 0.4 percent of GNP. From 1985 to 2003, the cost of the social security pension fell continuously to about 2 percent of GNP while the cost of the pension tax expenditure more than tripled to 1.4 percent of GNP as the government pursued its policy of developing the private pension system. Between 2000 and 2001, the cost of the pension tax expenditure fell as a result of the collapse of the dot com bubble. However, it recovered quickly and it rose to 1.9 percent of GNP in 2006 before falling back to 1.6 percent in 2007 as a consequence of the financial crisis.

Adding the cost of the tax relief for private pensions in Ireland to the cost of public social security expenditure on pensions provides a different perspective on the issue of the affordability of a universal state pension in Ireland. The addition of the tax expenditure on the private pension system in Ireland indicates that the resource cost of supporting the public social security and private pension systems has fluctuated around 4 percent between 1980 and 2007. There is scope, therefore, for reallocating resources between the public and private components of the pension system.

PROBLEMS WITH THE PRIVATE PENSION SYSTEM

The way in which pension tax relief is allocated to members of occupational and individual pension plans is inequitable. Figure 4.6 shows the distribution by income quintile of the tax relief on self-employed in 1999–2000 and employee contributions to occupational pension funds

Figure 4.6 Distribution by Income Quintile of Tax Relief on Pension Contributions by Employees in 2000 and Self-Employed Workers in 1999–2000

SOURCE: Hughes (2007, Figure 3.12).

in the year 2000. The distribution for both employment groups is much the same—the bulk of the tax relief accrues to the top 20 percent of earners (quintile 5 in Figure 4.6), while the bottom 20 percent receive virtually nothing. Two-thirds of the tax relief for employees and three-quarters of the relief for the self-employed accrued to people in the highest income quintile. The bottom 20 percent of employees and the self-employed received only 1.1 percent and 0.2 percent, respectively, of the tax relief. The distribution of the tax relief for the self-employed is more concentrated than it is for employees because the pension coverage rate for the self-employed is significantly lower than it is for employees.

The distribution of tax relief is concentrated at the top end of the earnings distribution because the effective limits on employee contributions in Ireland were largely determined by the maximum pension permitted under Revenue Commissioners rules that would attract tax relief, rather than by a maximum contribution. In Ireland, the pension benefit could not exceed two-thirds of pensionable salary, so this put an

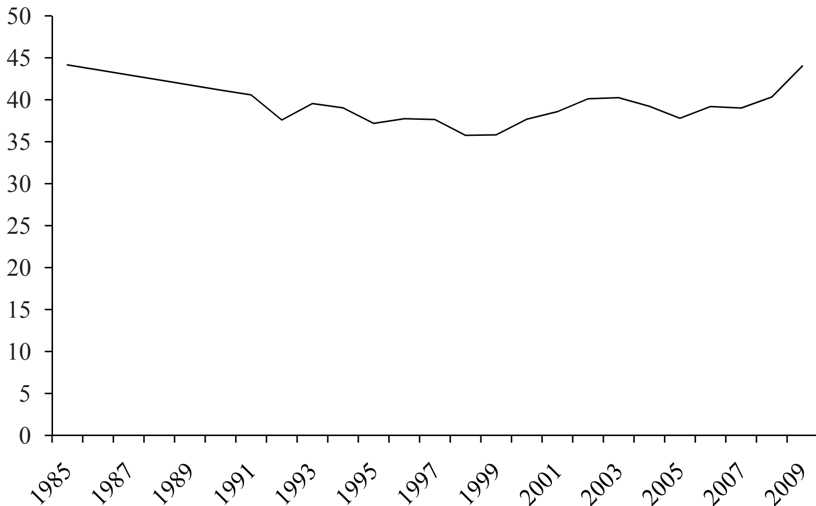
upper bound on how much could be contributed, although it varied with age and level of earnings.

Pension tax relief in Ireland is intended to increase the coverage of the private pension system and to provide an earnings-related supplement to the social welfare pension. Hence, one would expect the coverage of occupational pension plans to have risen over the last 20 years and the social welfare pension to be less important than private pensions in delivering an income in retirement. Let us consider, therefore, what has happened to private pension coverage and how effective public and private provision are in delivering retirement income to the older population.

Trends in the Coverage of Occupational Pensions

Figure 4.7 shows that the occupational pension coverage rate declined by 8 percentage points from 1985 to 1999. From 2000 to 2009, however, much of the ground lost was recovered so that the coverage rate was just under 45 percent at the start and end of the period shown in

Figure 4.7 Occupational Pension Coverage Rates, 1985–2009 (%)

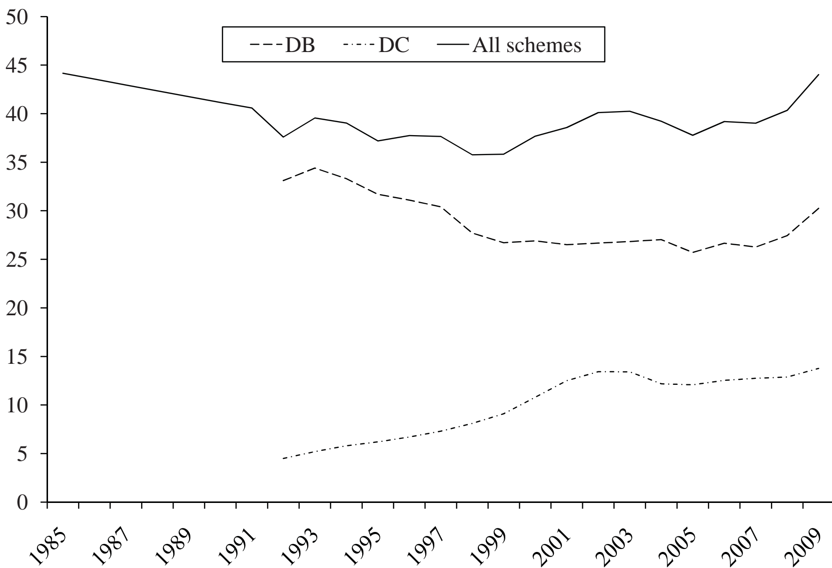


SOURCE: Hughes (2007, Figure 3.13) and authors' estimates.

Figure 4.7. A factor that may have contributed to this recovery was the very strong employment growth experienced between 1995 and 2006 when Ireland's economy grew at rates that were unprecedented since Independence in 1921.

It is evident, therefore, that the policy of providing generous tax relief to encourage the growth of occupational pension plans has not been effective in increasing pension coverage over the last 25 years. This failure has been compounded by a switch in coverage from occupational defined benefit plans to defined contribution plans, as Figure 4.8 shows. The switch to defined contribution plans places a big obstacle in the path to the achievement of the Pensions Board target of replacing 50 percent of preretirement income because the difference between the target for the social insurance pension (34 percent of average earnings) and the overall target has to be made up by a private pension.[5] The decision by employers to replace defined benefit with defined contribution

Figure 4.8 Percentage of Workers Covered by Defined Benefit (DB) and Defined Contribution (DC) Occupational Pension Schemes, 1985–2006



SOURCE: Pensions Board Annual Reports.

plans for most new entrants to the labor force means that there can be no certainty about what average level of pension the private sector can deliver.

Despite the uncertainty surrounding the average level of pension that can now be delivered by the private pension system, Ireland has put a lot of effort during the last 10 years into the development of a personal pension option in the hope that it would help to increase the pension coverage rate. The government's advisory body on pensions, the Pensions Board, identified a number of barriers to improving pension coverage (see Pensions Board 1998). It recommended that a standardized, low-cost personal retirement savings option should be made widely available irrespective of employment status.

The government accepted the Board's recommendation, and it introduced the PRSA in 2003 for employees and others not covered by an occupational plan or an RAC. The government made it mandatory for employers to designate a PRSA provider, but it did not require the employer to make a contribution on behalf of employees. Age-related tax incentives were provided to encourage people to start saving for retirement. Anyone under the age of 30 taking out a PRSA is allowed to claim tax relief on contributions of up to 15 percent of earnings. The percentage of earnings on which tax relief can be claimed increases with age until it reaches 40 percent for those aged 60 and over.

PRSAs operate like defined contribution pension plans, but their charges are considerably higher than those for occupational plans as they do not benefit from the economies of scale accruing to group plans. It was hoped that tax relief, and the mandatory requirement for employers to provide access to a PRSA, would result in a significant increase in pension coverage within five years of the introduction of the PRSA. This expectation has not been met. Seven years after the introduction of PRSAs, coverage had increased by only 2 percentage points, from 52 percent in the first quarter of 2002 to 54 percent in first quarter of 2008.

The failure of a voluntary approach to increasing pension coverage has resulted in the publication of a National Pensions Framework (Department of Social and Family Affairs 2010) in which the government proposes to increase coverage by introducing an auto-enrollment plan for employees who are not covered by their employer's plan. Very few details are provided about how this plan will work. It is worth noting that the option of a quasi-mandatory addition to the Irish pension

system was considered in the Green Paper on Pensions and a decision was deferred because "It would be useful, perhaps, to allow time for more evidence on performance of soft mandatory schemes elsewhere to emerge, particularly from New Zealand" (Department of Social and Family Affairs 2007a, par. 8.54). To date, the government has not produced any evaluation of how the auto-enrollment plan has worked in New Zealand, but St John, Littlewood, and Dale (2010) have shown that the New Zealand plan has required significant subsidies from the government to achieve the large number of enrollments that have occurred to date.

EFFECTIVENESS OF PENSION DELIVERY

A key issue in designing an ideal pension system is determining how effective the public and private components are in delivering pensions. One way to look at this issue is in terms of what proportion of the target population actually receives income from each component.

Despite all the tax relief, the long-term existence of occupational pensions, and various government initiatives, state welfare pensions and other transfer payments provide the bulk of income to retired persons. These and other points can be deduced from Household Budget survey data for the 2004–2005 period. The data consist of a randomly chosen cross-section survey of 6,884 households. Because the raw data are based on households,[6] they were converted into a per capita equivalent basis using standard adjustment techniques. Table 4.3 shows the numbers of those aged 65 and over reporting income from various sources. Not all of those aged 65 and over report pension income, but the number of people reporting occupational pension income is less than half of those included in the survey. Over 70 percent of respondents report income from the state social security pension; slightly over 50 percent report financial income and just under 30 percent report earned income.

Table 4.4 shows income per capita broken down by various sources. The main features of Table 4.4 are as follows:

- Mean and median gross income decline with age, except for income from state welfare pensions.

- Income from various state welfare pensions accounts for 38 percent of total income for those aged 65–74 and 53 percent of income for those aged over 75.
- Mean income from occupational pension coverage is low, and median values are zero, indicating that most of those included in the survey do not receive an occupational pension.
- Financial sources of income are low and highly skewed; the median values are zero.
- Non-pension income accounts for 28 percent of mean income for those aged 65–74 and 13 percent of those aged 75+. This represents a significant reliance of retired persons on sources of retirement income other than pension income, mostly representing paid work.

The small number of those with occupational pensions is surprising, but it is of interest to examine incomes for those reporting occupational pension income. Table 4.5 shows income data for those with pensions from state employment. Even for those with occupational pensions from state employment, state social welfare payments are important, accounting for 30 percent of mean pension income for those aged 75+, or 38 percent of median pension income. Mean income from financial assets is higher than for the entire survey group but still low. Non-pension income is lower than for retired persons as a group in the survey, at 18 percent of mean income.

Table 4.5 also shows the same data for those who report pension income from non-state employment. The gross income and pension income are lower for all age groups compared with those who report pension income from state employment. For example, for those 75 and older, median pension income is almost 30 percent lower than those reporting pension income from state employment. The gap is even larger for those aged 65–74 (35 percent). However, gross incomes are closer, at about 81 percent of the level of those with a pension from state employment because financial income and income from paid work are higher.

Table 4.5 also shows an inequality in pension income (and gross income) between those groups reporting pension income from state employment as compared with those reporting pension income from non-state employment. The median pension income as a percentage of

Table 4.3 Numbers of Those Aged 65 and Over Reporting Income from Various Sources

Age	Gross household income (€)	Total pension income from all sources (€)	Income from state employment pension	Income from other employment pension	Income from all state social security pensions[a]	Financial income	Earned and other income
65–74	871	831	138	257	630	475	314
75+	573	557	81	136	440	251	107
Total	1,444	1,388	219	393	1,070	726	421

NOTE: The cells do not sum to the number of respondents in the survey because some people reported income from multiple sources.
[a] State old-age pension, state retirement pension, widows' pensions, and blind person's pension.

Table 4.4 Sources of Pension Income (€per week)

		Total gross household income[a]		Total pension income from all sources		Income from state employment pension		Income from other employment pensions		Income from all state social security pensions[a]		Total other financial income		Earned and other income	
Age	*N*	Mean	Med.	Mean	Med.	Mean	Med.	Mean	Med.	Mean	Med.	Mean	Med.	Mean	Med.
65–74	871	339	242	221	185	43.2	0	48.4	0	129	166	10.5	0.4	83.7	0
75+	573	276	203	219	187	35.1	0	37.8	0	146	176	9.6	0.0	27.3	0
Total	1,444	314	216	220	187	40.0	0	44.2	0	136	173	11.0	0.1	61.3	0

NOTE: Not all income is shown by source. Hence the individual rows do not sum to total gross mean income.
[a] State old-age pension, state retirement pension, widows' pensions, and blind person's pension.

Table 4.5 Income for Those Reporting Pension Income from State Employment Pensions, Non-State Employment Pensions, and No Occupational Pensions (€per week)

		Total gross household income[a]		Total pension income from all sources		Income from state employment pension		Income from other employment pensions		Income from all state social security pensions[a]		Total other financial income		Total earned income	
Age	*N*	Mean	Med.	Mean	Med.	Mean	Med.	Mean	Med.	Mean	Med.	Mean	Med.	Mean	Med.
State employment pension															
65–74	138	465	413	377	370	273	238	12	0	92	101	14	6	61	0
75+	81	444	387	378	356	248	214	15	0	115	135	19	2	28	0
Total	219	457	403	377	359	264	230	13	0	100	105	16	4	49	0
Non-state employment pension															
65–74	257	424	334	295	242	16	0	164	0	115	132	19	2	91	0
75+	136	355	293	289	252	15	0	159	0	114	138	14	0	25	0
Total	393	400	326	293	244	16	0	162	0	115	132	17	1	68	0
No occupational pension															
65–74	498	267	193	145	174	0	0	0	0	145	174	4	0	88	0
75+	367	218	193	163	180	0	0	0	0	163	180	5	0	29	0
Total	865	246	193	153	175	0	0	0	0	153	175	4	0	63	0

NOTE: Not all income is shown by source. Hence the individual rows do not sum to total gross mean income.

[a] State old-age pension, state retirement pension, widows' pensions, and blind person's pension.

Table 4.6 Gender of People with and without Occupational Pensions for Single-Person Households

Age	Without occupational pension	Male	Female	With occupational pension	Male	Female
65–75	235	87	148	125	54	71
75+	222	69	153	98	38	60
Total	457	156	301	223	92	131

average income varies between 73 and 87 percent for those reporting pension income from non-state employment, compared with 94 to 98 percent for those reporting income from state employment.

Gross income and pension incomes of those with pension income from non-state employment, while lower than those with pension income from state employment, is still higher than the average pension income of all retired persons in the survey. The reason for this is the much lower pension income of those with no occupational pension income, as shown in Table 4.5. The gap between median pension income and median gross income is not large, but the gap between mean gross income and mean pension income is the largest in percentage terms of the separate groups examined. This reflects the relatively higher contribution to income from paid work for this group

Apart from considerable differences in pension income between those who report occupational pension income as compared with those who do not, there are also large differences in pension income by gender. Table 4.6 shows the gender of those reporting no occupational incomes for single-person households only. People without an occupational pension are predominantly female. There are nearly twice as many single females as males living alone without any occupational pension. Although not shown in the table, their incomes are one-third to one-half of those with occupational pensions. Females also make up the majority (60 percent) of those living alone with an occupational pension.

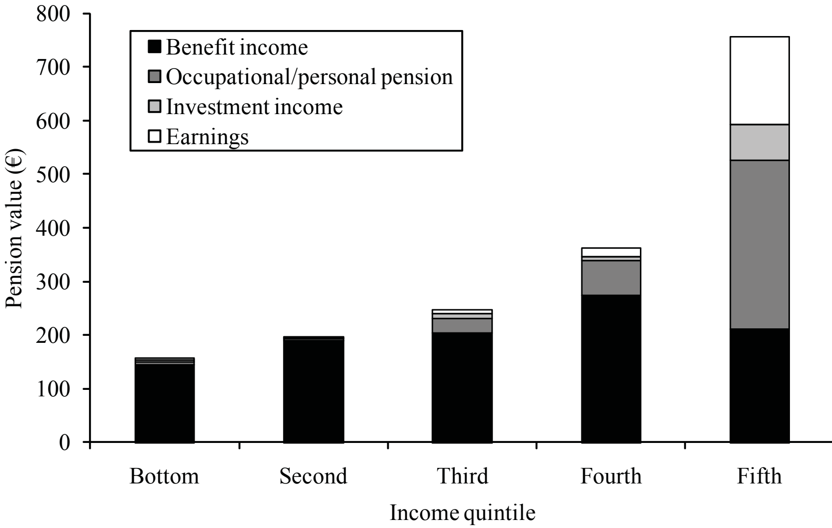
Table 4.7 shows occupational pension income broken down by state employment pension, non-state employment pension, and gender for single-person households (hence the numbers of respondents are smaller). Median pension income is highest for females with a state occupational pension, and there is also less dispersion in female pension

Table 4.7 Occupational Pension Income (€per week) by Gender

	State pension income						Non-state pension income					
	Male			Female			Male			Female		
Age	*N*	Mean	Median	*N*	Mean	Median	*N*	Mean	Median	*N*	Mean	Median
65–74	19	272	217	31	304	333	35	219	140	40	168	154
75+	11	375	214	22	230	239	29	182	144	39	151	120
Total	30	310	215	53	274	268	64	202	142	79	159	125

NOTE: Not all income is shown by source. Hence the individual rows do not sum to total gross mean income.
[a] State old-age pension, state retirement pension, widows' pensions, and blind person's pension.

Figure 4.9 Value of All Pension Unit Incomes by Source and Income Quintile



SOURCE: Department of Social and Family Affairs (2007a, Table 4.4).

income—the mean and median values are much closer in all cases. For those reporting non-state occupational pension income, the median income is higher for males aged 75+ but not for those aged 65–74.

Finally, the minor role that the private pension system and other sources of income play in providing retirement incomes in Ireland becomes even more evident when the data are disaggregated by income quintile to show how much income pensioners in different quintiles receive from each income source (Figure 4.9). State pensions account for almost all of the income received by pensioners in the first four quintiles. Private pensions and other income provide a significant part of total income only to the group at the top of the income distribution. Private pensions, investments, and earnings provide around three-quarters of the total income of pensioners with the highest incomes. This is hardly surprising given the skewed distribution of pension tax relief in favor of the highest earners.

THE FAILURES AND SUCCESSES OF IRELAND'S PENSION SYSTEM

Our evaluation of the pension system in Ireland in terms of simplicity, adequacy, cost, equity, coverage, and effectiveness in delivering pensions leads to a number of conclusions. The main defect of the Irish public pension system is that it has failed to eliminate pensioner poverty. Successive governments' preferences for a public system that provides only a subsistence income in retirement and for a private system that is supposed to provide an earnings-related top-up has focused attention on the cost of the public social security system while the cost of Exchequer support for private pensions has been largely ignored. The cost of the tax expenditure for private pensions in Ireland is now nearly as great as the cost of direct expenditure on the public social security system. Consequently, when the cost of the tax expenditure is factored in, the aggregate cost of pension provision has fluctuated around 4 percent of GNP for the last 30 years.

Contrary to expectations, the provision of generous tax relief for private pensions has not increased the coverage of occupational pensions. Most of the benefits of the tax relief for private pensions have been appropriated by the very highest earners. This occurs at the expense of taxpayers, most of whom generally receive little benefit from the favorable tax treatment of private pensions.

PROPOSED REFORMS: NATIONAL PENSIONS FRAMEWORK

The recently published National Pensions Framework (Department of Social and Family Affairs 2010) sets out the government strategy on pensions. It states that the government "will seek to sustain" the state social security pension at 35 percent of average weekly earnings. It is currently at 32 percent. It will also become easier for some groups to qualify. There will be tax reform, but rather than granting all relief at the standard 20 percent rate, relief will be granted at a 33 percent rate, and rather than eliminating the tax exemption from lump sum payments, the

maximum tax-free lump sum will be reduced to €200,000 ($256,000), which exempts from tax the lump sum payable to the most senior civil servants.

The National Pensions Framework proposes an individual pension plan in addition to those already in existence (Additional Voluntary Contribution, PRSA, Approved Retirement Fund, and others) but only for those without pension coverage (Department of Social and Family Affairs 2010, pp. 29–31). This proposed plan has all the signs of an initiative led by the pension industry. There will be auto-enrollment (with an opt-out option), funds will be invested, and as noted above there is the typical industry analysis of returns assuming a constant 7 percent per year, in real terms, for 40 years (Department of Social and Family Affairs 2010, Table 4.1, p. 32).

It is most unlikely that this plan will succeed in providing adequate retirement income. The contribution periods of workers will be less than forecast, given periods of unemployment, working abroad, or caring for children and other family members. Financial market returns will certainly not be as forecast. In addition, the proposed contribution level as a proportion of salary is too low (8 percent) to provide retirement income as forecast in government proposals. In addition, the proposals do not attempt to quantify the extra risk borne by members of the new plan.

There is a danger that employers will see this new plan as a cheaper alternative to existing plans because they may contribute 2 percent of salary to the new plan, whereas contributions to existing defined contribution plans have been reported to be 11 percent of salary and contributions to defined benefit plans are 16 percent of salary. More recently a figure of 6 percent has been cited as the average contribution rate to defined contribution plans. Thus employers may seek to switch employees from an existing defined benefit, or more likely defined contribution plan, to the new cheaper plan. A similar trend has occurred in the United States with 401(k) plans.

The cost of the new plan (managing funds, a tracking mechanism to keep track of mobile workers, and managing dormant accounts) will be expensive, as has been shown to be true in Australia. For small accounts, fees over time could reduce sums considerably.

Government proposals also involve reform of pensions in relation to state employment. The main proposed reforms for new entrants involve increasing the retirement age to 66 and basing pensions on career

average earnings. The main proposal in relation to existing and future public service employees is that the consumer price index rather than final salary will be used as the basis for post-retirement pension increases.

The new government proposals have nothing to say about the National Pension Reserve Fund. Perhaps this is because the reserve fund is now essentially a vehicle to provide finance to the Irish banking system. Originally it was intended to partially prefund future state employee and social welfare pensions and was hailed by some commentators as the most important initiative in a decade.

The government-proposed reforms have little to offer to members of defined benefit plans in actuarial deficit. A particular concern for many employees is that their employer may be unprofitable or insolvent as a result of property speculation, over-borrowing, and extraordinarily poor management.

The government proposals, however, devote some space to advocating programs of financial education for individuals relating to retirement planning and summarizing the considerable state effort at financial education for individuals. However, financial education is not the key to successful retirement planning or financial decision making, as Ghillarducci (2008, p. 137) notes.

Finally, there is a proposal that the earliest age at which the state social security pension can be received will increase to 68 starting in 2014. There is no discussion of enhanced benefits as a result. Increasing the retirement age may be welcome by some groups with particular skills, for example, professional groups such as lawyers. But for those working in hazardous or physically demanding employment, increasing the retirement age could substantially reduce the period of retirement. It is therefore regressive, representing a transfer from those who are less well off and with lower life expectancies to those who are better off and with higher life expectancies.

These proposed reforms do not address the issues of equity and efficiency. The ultimate viability of any pension system depends on the future productivity of an economy. Unless issues of equity and efficiency are addressed, future productivity will be adversely affected.

THE KEY TO DEVELOPING AN IDEAL PENSION SYSTEM FOR IRELAND

Despite the poor performance of private pensions, the National Pensions Framework proposals for the future development of the pension system aim to maintain the social welfare pension at a subsistence level of about one-third of average earnings and to try to increase the coverage of the private pension system. It is hoped this can be done by automatically enrolling employees who are not covered by an occupational plan in individual pension accounts that would be managed by the private sector. This proposal flies in the face of the evidence that the social security public pension system is far more effective than the private system in delivering pensions and in providing the bulk of retirement income. Only a small minority of pensioners at the top of the income distribution receive significant benefits from the private pension system.

The evidence on the performance of the two components of Ireland's pension system strongly suggests that the opposite should be done in an ideal system. There should be a larger role for the public component rather than for the private component of the pension system.

The current system could be developed in ways that draw on the strengths of the public component and begin to correct the inequitable treatment of taxpayers who gain little from tax relief for private pensions. Ireland is not, of course, starting with a clean slate. Pension systems are to some extent path dependent, so it is not being suggested that Ireland should ignore what has been done in the past. What would be possible is to change the balance of pension provision in favor of the social security public system.

Elements of an Ideal Pension System for Ireland

The evidence presented above shows that the public component of the pension system is doing a far better job of delivering an income in retirement than the private component, that it is currently providing retirement income for over 90 percent of pensioners, and that its benefits are not high enough to prevent poverty in old age. To build on the strengths of the social security public pension system and to address

its weaknesses, the TCD Pension Policy Research Group (see Hughes 2007; McCashin 2005; Stewart 2005) proposed that the tax incentives for private pensions should be at the standard rate of tax rather than the marginal rate; the flat-rate social welfare pension should be increased to 40 percent of earnings to bring it above the poverty level; it should become a universal benefit, similar to New Zealand's superannuation, which would be payable to every pensioner on the basis of residence in the country for a specific period of years; and a second-tier social security pension should be introduced to top up the universal pension to 50 percent of earnings.

A universal social security pension funded out of general taxation would be distinctively redistributive, it would ensure pensions as of right for men and women, and it would abolish the means test for pensions. The transformation of the current social security system into a second-tier earnings-related pension recognizes the strong social and political attachment to work-based pensions in Ireland. The social security pension would not require dependents' additions because dependents would be entitled to a pension in their own right under the proposal for a universal state social security pension. This would strengthen the role of social security as a benefit derived from participation in the labor force. The pension could be flat rate, as it is now, or it could be related to earnings. This design "recognises the fact that a pensions system, of necessity, must incorporate a number of competing values, that reform must build to some extent on existing provisions and expectations, and command broad public support" (McCashin 2005, p. 117).

At present, Ireland is using social security pensions to try to achieve a number of different objectives: the prevention of poverty in old age; the provision of support for pensioners' dependents; the maintenance of contribution records during periods of unemployment, illness, or temporary withdrawal from the labor force; and the provision of adequate income during retirement. It is difficult to achieve this multiplicity of objectives with just one instrument. The introduction of a universal state social security pension and a state earnings-related pension would separate the goal of poverty prevention from that of income maintenance and permit the development of policies that would have a better chance of achieving each objective.

The increase in the state basic social security pension would be paid for by giving tax relief for private pensions at the standard rate of

Table 4.8 Distribution of Gains and Losses from Using the Standard Tax Rate for Pension Tax Relief and Increasing the Social Welfare Pension Above the Poverty Level and Percentage Change in Income by Income Decile, 2005

Income decile	Gain or loss (€ million)	Percentage change in income
1	10.80	0.6
2	160.10	6.4
3	264.80	10.0
4	122.80	3.3
5	26.40	0.5
6	−18.70	−0.3
7	−58.10	−0.8
8	−137.60	−1.7
9	−299.90	−3.1
10	−435.60	−3.1
All	−365.00	−0.6

NOTE: The Social Welfare Pension is assumed to increase by €38 per week.
SOURCE: Callan, Keane, and Walsh (2009, Tables 5.1 and 5.4).

tax. The earnings-related component would be paid for by increasing employer and employee Pay Related Social Insurance Contributions (PRSI) and using some of the revenue released by standard rating the tax relief of private pensions. This approach would enable Ireland to eliminate pensioner poverty at a cost it could afford and at the same time contribute to the long-term sustainability of the public social security pension system. This approach also has the very considerable advantage that it is the only one that would improve the position of existing pensioners. Policies that rely on the private pension system to improve pensions will do nothing for existing pensioners because a long period of time is required for assets to build up to a level that could provide even a modest improvement in living standards.

Is the Ideal Pension System for Ireland Affordable?

The proposals for the ideal pension system for Ireland pose a key question: are they affordable? Researchers at the Economic and So-

cial Research Institute (ESRI) in Dublin have used a micro-simulation model to estimate the cost of implementing this policy (see Callan, Keane, and Walsh 2009). They simulated what would have been the cost in 2005 of increasing the social welfare pension by €38 ($48) per week, which would have brought it just above the poverty level, and financing the increase in the pension by giving tax relief on private pension contributions at the standard rate of tax rather than the marginal rate. The outcome of this exercise is shown in Table 4.8. The effect of using the standard rate of tax relief on pension contributions would be to release almost €950 ($1,216) million in tax revenue forgone from taxpayers in the sixth to the tenth deciles. Just over three-fifths of this sum, or €585 ($749) million, would be required to bring nearly all pensioners above the poverty level (i.e., by increasing all social security and social assistance pensions by €38 [$48] per week). The losses for taxpayers in the top five income deciles would range from −0.3 percent to −3.1 percent of income, while the gains for those in the bottom half of the income distribution would range from 0.5 percent to 10 percent of income. The biggest losses would be borne by taxpayers in the top two income deciles who would contribute to the Exchequer almost 80 percent of the additional revenue that would be raised by using the standard tax rate for tax relief on pension contributions, a result that is hardly surprising in view of the evidence presented previously showing that the bulk of pension tax relief accrues to taxpayers at the top of the income distribution.

Callan, Keane, and Walsh (2009) also calculated the effect of using the standard rate for tax relief and raising the social welfare pension on the "at risk of poverty" measure for pensioners. They found that the pensioner poverty rate would fall by almost 90 percent, from 25.9 percent of households headed by a pensioner to 2.8 percent.

If the state social security pension were brought up to 40 percent of earnings, a 10 percent gap would remain between the first-tier pension and the replacement rate target of 50 percent of preretirement income set by the Pensions Board for the average worker. The objective of the proposal for a second-tier social security pension is to close this gap. Estimating how much it would cost to do so would necessitate complex simulations requiring access to a long-term projection model that is not available to us. However, in its *National Pensions Review*, the Pensions Board (2005) considered a mandatory state social security earnings-

related system (Alternative 4) that would provide a flat-rate pension of 34 percent of average industrial earnings and a supplementary social security earnings-related payment that would provide a benefit close to the 50 percent target for a substantial additional number of workers. The earnings-related component would provide a benefit of 1 percent of annual pensionable earnings between the minimum income for PRSI payment and twice average industrial earnings. Annual earnings would be revalued at retirement to take account of inflation and the benefit would be based on career average earnings. Projected retirement income replacement rates under Alternative 4 range from 68 percent for those with half average earnings, to 55 percent for those with average earnings, and 47 percent for those with twice average earnings.

The additional contributions required to pay for an earnings-related social insurance pension would be equivalent to about 5 percent of labor force earnings. To meet the full cost of the existing flat-rate social welfare pension and the Alternative 4 earnings-related component, the contribution rate required for a new entrant to the labor force would be 26.5 percent of pensionable earnings within the limits described above. Although we differ with some of the assumptions underlying this alternative, it is the closest in spirit to our proposal and it gives a broad indication of the long-term costs and benefits of the proposal.

If Alternative 4 were operated on a pay-as-you-go basis, rather than funded as the Pensions Board prefers, it would result in a substantial improvement to the Exchequer finances in the first decade of its operation and no increase in cost through 2056 over the current system of flat-rate state social security pensions and tax relief for private pensions. The Pensions Board (2005, p. 253) describes this outcome as "illusory" because it assumes costs would increase after 2056. However, it is worth noting that even if Alternative 4 were funded, it would cost just 1.6 percent of GNP more now than the current system and 0.3 percent more in 2056. On average in the period up to 2026, it would cost 1.3 percent of GNP, or 0.3 percent more than the annual contribution to the National Pension Reserve Fund.

CONCLUSION

The proposal to introduce a universal social security pension and to reduce the tax relief for retirement saving is not as dramatic as it might seem at first sight (see McCashin 2005). The state social security pension system is already providing the bulk of retirement income for the great majority of pensioners in Ireland. The tax relief for retirement saving has not succeeded in increasing coverage of occupational pension plans, and the tax incentives for personal pensions (PRSAs) have had little effect on coverage, especially at the lower end of the income distribution. The cost of expenditure on the public social security pension system and the tax expenditure on the private pension system in Ireland are now almost the same. Consequently, there is scope for a reallocation of resources between the public and private components of Ireland's pension system.

An important advantage of the proposed strategy is that it would provide a secure framework for people who wish to save to maintain a reasonable relationship between their income from work and their income in retirement. It would improve the living standards of current pensioners, contribute to the elimination of pensioner poverty, improve the equity of the tax system, provide equal treatment for men and women, and contribute to the long-term sustainability of Ireland's public pension system. Finally, it would strengthen the public social security component of the pension system which is already nationally established, politically accountable, and enjoys public credibility and legitimacy.

Notes

1. For example, the introduction of 401(k) plans in the United States has been associated with a collapse in retirement income. See Ghilarducci (2008, pp. 56–57).
2. Although governments in Ireland have never committed themselves to formally indexing pensions, they have maintained a close relationship with average industrial earnings since the contributory old-age pension was introduced in 1961. Over the period 1961–1998, the average personal rate of the contributory pension was about 25 percent of average industrial earnings. Following a recommendation in 1998 by the Pensions Board (1998) that the personal contributory pension be increased to 34 percent of average industrial earnings, it increased to about 30 per-

cent of average industrial earnings in the period 1998–2007. In 2007 it reached the 34 percent target set in the Pensions Board report (see Hughes and Watson 2005).

3. The at risk of poverty rates for Ireland in Figures 4.1 and 4.2 differ because the rate in Figure 4.1 is primarily based on a national definition that includes income from private pensions whereas Figure 4.2 is based on an EU definition that excludes such income. For further information, see Central Statistics Office (2009).
4. The exchange rate on June 30, 2006, was €1 = $1.28, and this rate is used throughout the paper to convert euros into U.S. dollars.
5. The Pensions Board replacement rate targets of 34 percent and 50 percent are modest. Munnell and Quinby (2009, p. 3) point out that "as a general benchmark, retirement income equal to 65 to 80 percent of pre-retirement earnings should be more or less adequate."
6. The accuracy of the data depends on the accuracy of information given by independent households. For example, the Household Budget Survey notes (Central Statistics Office 1997, p. 6) that, "no adjustment is made for the understatement of expenditure, for example [on] alcoholic drink which is a traditional national and international phenomenon in household expenditure surveys of this type." In addition, the Central Statistics Office (2001, p. 5) comments that, "some categories of income tend to be underestimated in surveys of this nature."

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