Submission by Brian Woods and Colm Fagan to Meeting of Statistical and Social Inquiry Society of Ireland on 25 May 2023

This note discusses the first recommendation in Whelan & Hally's paper, presented to the Statistical & Social Inquiry Society of Ireland on 25 May 2023[1]:

> *"First, we show that the existing tax reliefs for other pension arrangements are considerably more valuable than the 33% subsidy to contributions to the AE Plan for higher rate taxpayers. To create a level playing field for the new AE Plan, we recommend qualifying contribution levels be equalised and that tax relief on contributions to other pension arrangements be abolished, replaced with the common 33% subsidy."*

Our analysis ignores the tax-free lump sum, which is a normal additional benefit in both public and private sector pension schemes. There is general agreement that the tax-free lump sum has no theoretical justification.

In discussing the above recommendation by Whelan and Hally, we will:

- Outline the theoretical rationale for the EET system under conventional pension plans.
- Expand on the disadvantage of the proposed 1 for 3 top-up under Automatic Enrolment (AE) for taxpayers entitled to higher rate relief under a conventional pension.
- Discuss Whelan & Hally's two suggestions for eliminating this tax disadvantage, and
- suggest a third approach to achieving the desired aim.

The Exempt, Exempt, Taxed (EET) system for pension tax relief

There is a widespread misconception that Ireland's pension taxation system was designed specifically to encourage/incentivise pension savings. Sales brochures by the pensions industry would certainly give that impression. And as Whelan& Hally[2] observe, the incentives are regressive. The incentive peaks in the middle-income bracket and tapers off at higher incomes as the marginal 40% income tax and 8% USC on pensions in payment counter to some extent the 40% tax relief on contributions and the exempt investment income.

Why would the State wish to incentivise pension savings? We must distinguish between the "safety net" and a pension to keep someone at a standard of living comparable to what they enjoyed during their working life. The safety net should be a mandatory provision by society whether or not through the tax system, funded by earmarked taxation (PRSI) or through a mandatory savings regime; however, there is no compelling reason why the State should incentivise or mandate saving for pensions in excess of the safety net.

So why has our current EET system evolved? It has evolved to ensure a level playing field in the labour market between at the one extreme the State and (large) companies which can remunerate employees through a combination of salary and pension, and at the other extreme the self-employed. Ireland has a progressive income tax system, structured around the calendar year, which of itself encourages deferral or spreading of income from high-earning years to low-earning ones. To

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[1] https://www.ssisi.ie/_files/ugd/463248_402a53b4db384014a764bd0f567990bc.pdf

[2] See also Shane Whelan & Maeve Hally, 2018. "**An Analysis of Taxation Supports for Private Pension Provision in Ireland**," The Economic and Social Review, Economic and Social Studies, vol. 49(3), pages 319-359.

level the playing field, the self-employed in particular would need some proxy to this income spreading/ deferral. A theoretically correct way to achieve this is through the EET system. That is, contributions to pension savings are considered as deferral of income and are therefore exempt from income tax in the year that they are made; investment of those contributions is exempt from tax to equate with the discounting rate that would be appropriate to the State or companies; and finally, when the income is eventually taken in retirement it is subject to income tax.

Now clearly the fact that Ireland's income tax system is progressive on an annual cycle, as mentioned above, and that investment income outside the system is taxed gives the EET system a high incentive which is unavoidably regressive, being a spreading of a progressive system with annual rests, as observed by Whelan & Hally.

When it comes to AE we see for the first time an incentive being introduced for its own sake. As Whelan & Hally demonstrate, the 1 for 3 top-up, when applied to low-income employees, is not driven by the deferred income considerations that led to the EET system. This explicit top-up incentive for low earners is unusual and was not for example adopted in the UK equivalent AE system. We are not opposed to this incentive but the rationale merits close examination. Is its purpose to strengthen the safety net, rather than provide for a comfortable retirement? If the former then one might query why there is any voluntary dimension to it, but that is for another day.

Disadvantage of 1 for 3 top-up versus 40% tax relief for high earners

We agree with Whelan & Hally's observation that the 1 for 3 top-up for AE is considerably less valuable than 40% tax relief on conventional pension plans for those earning between the standard rate cut-off and the €80k AE limit. (1 for 3 top-up is slightly more valuable for those whose marginal tax rate is 20% and, of course, those outside the tax net get no benefit under the conventional system.)

The report[3] of the Joint Oireachtas Committee (JOC) on scrutiny of the Heads of the draft Bill implementing AE commented on this in Key Issue 9. The committee had produced an example showing that foregoing 60 take home pay under a conventional pension plan would secure a pension contribution of 100, which would be 25% higher than the 80 secured by the AE 1 for 3 subsidy. The Department of Social Protection (DSP) itself had produced an example illustrating this 25% disadvantage for AE (albeit in a more convoluted manner).

Level playing field in tax treatment of AE and conventional pensions

We thus agree entirely with Whelan & Hally that there should be a level playing field between the tax treatment of AE and conventional pensions. Besides the issues of credibility and fairness it would be extremely undesirable to have two systems running side by side with one system more favourable up to a certain earnings level and the other more favourable above that level. In extreme this would lead to employers running both systems and dynamically re-adjusting which system the employee should be in, depending on their tax position.

For avoidance of doubt, we are not arguing that there should be no difference between AE and conventional pensions. For example, a conventional pension may provide greater flexibility in

[3] The JOC's report can be found at https://data.oireachtas.ie/ie/oireachtas/committee/dail/33/joint_committee_on_social_protection_community_and_rural_development_and_the_islands/reports/2023/2023-05-03_report-on-pre-legislative-scrutiny-of-the-general-scheme-of-the-automatic-enrolment-retirement-savings-system-bill-2022_en.pdf

relation to investment options, etc. and, if Fagan's idea[4] for a smoothed approach to investment is adopted, this would be unique to AE. But these would be more or less permanent differences and would not require dynamic readjustment.

Reverting to how a level playing field on tax treatment might be achieved, Whelan & Hally suggest two alternatives. The first is to increase the AE subsidy so that the 25% disadvantage is reduced or eliminated. To eliminate the disadvantage would require a 2 for 3 subsidy – twice what is proposed and would come at considerable extra cost to the taxpayer. In any case, it would leave conventional pensions at a disadvantage in most situations and would not therefore be levelling the playing field. A compromise in-between subsidy would still leave the invidious incentive for dynamic readjustment. Whelan & Hally reject this option, as do we.

Instead, Whelan & Hally suggest that the conventional tax treatment should be replaced with a 1 for 3 subsidy across all income levels as currently proposed for AE. This echoes DSP's comment to the JOC that it was Government policy that the AE subsidy should be the same across all income levels, although DSP was not recommending this approach for conventional pension arrangements.

We disagree with Whelan & Hally. A 1 for 3 subsidy across all income levels would undermine the fundamental fairness of the EET system as outlined above and would distort the playing field across the labour market. Furthermore, it would at the margin be a disincentive to pension provision, as it could mean effective 25% relief on contributions and 48% combined income tax and USC on benefits for higher rate taxpayers.

Best of both worlds

So how can a level playing field be achieved between the tax treatment of AE and conventional pensions whilst retaining the 1 for 3 subsidy for low incomes? Woods, in his submission to the JOC, which was reproduced in their report[5], suggested that contributors should simply get the "best of both worlds". In other words, all AE contributions should get the 1 for 3 top-up but they should also be entitled to tax relief in the same way as a conventional pension. Double incentivisation would be eliminated by negative tax credits. The DSP had argued in its submission to the JOC that "best of both worlds" would be too onerous on the taxpayer. This is a gross exaggeration. In any case it relies on ignorance, as dynamic readjustment can always ensure the "best of both worlds". For consistency the conventional approach might be granted entitlement to minimum relief of 1 for 3, which should not be too costly.

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15 May 2023

[4] Which can be found at: https://actuaries.org.uk/media/q42dthzb/colm-fagan.pdf
[5] On pages 27 and 28 (of 76):
https://data.oireachtas.ie/ie/oireachtas/committee/dail/33/joint_committee_on_social_protection_community_and_rural_development_and_the_islands/reports/2023/2023-05-03_report-on-pre-legislative-scrutiny-of-the-general-scheme-of-the-automatic-enrolment-retirement-savings-system-bill-2022_en.pdf