Pensions Policy Research Group

Submission to 'Strawman' Consultation Process

on Automatic Enrolment Retirement Savings in Ireland

Submission on behalf of the Pensions Policy Research Group (PPRG)

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Introduction

This document was composed by the Pensions Policy Research Group (PPRG) and responds to the request by the Government and DEASP for interested parties to contribute to discussion of *A Roadmap for Pensions Reform 2018-2023* and specifically Strand 2 of that Roadmap and the associated Strawman proposals illustrating the proposed Automatic Enrolment Scheme for Ireland. (DEASP, 2018A; 2018B).

The PPRG is a voluntary, not-for-profit network of researchers and analysts with interests and expertise in pension policy and was established in 2004. We are an independent and inter-institutional network. Currently, the membership includes individuals from Maynooth University, NUI Galway, Social Justice Ireland, Trinity College Dublin, University College Cork, University College Dublin, and Waterford Institute of Technology, as well as individual and corporate members from the civil society and the voluntary sector. The key objectives of the PPRG are to foster individual research and scholarship by members of the group and to and facilitate debate and reflection on pension policy. The research and policy interests of PPRG members include:

- Reform of the public and private pension systems

- European comparative pension system studies

- Pension system equity

- Cost and distribution of pension tax reliefs

- The cost and effectiveness of individual pension accounts

- Pensioners' incomes

- Gender and pensions

- Pension communication

- Demographic projections and the sustainability of the pension system

- The interaction between the public and private pension systems

- The effects of increased reliance on private pension provision on income inequality

The PPRG provides an annual forum to share academic and policy research relevant to pension policy with a wide variety of stakeholders, including the civil service, the pensions industry, as well as trade unions and other civil society organisations. In addition, the PPRG facilitates meetings and workshops where civil society groups can come together to examine and discuss pension system reform proposals. More details about the groups are available at: http://www.pprg.ie

The immediate background to this submission is the series of PPRG events and seminars related to the National Pensions Framework, and specifically the government's proposed reform of social insurance to a total contributions approach (TCA) and the planned introduction of auto-enrolment (AE). In June 2018, PPRG convened a seminar for civil society groups on the TCA initiative, and at end-September 2018 held a workshop with participants from various civil society and advocacy organisations. The latter workshop was structured around the Department of Employment Affairs and Social Protection's publication *A Strawman Public Consultation Process for an Automatic Enrolment Retirement Saving System for Ireland*. The aim of the workshop was to provide a forum to assist organisations identify and evaluate policy issues relevant to them, so that they in turn can make informed submissions in relation to AE. Organisations that participated included Irish Senior Citizens' Parliament, Mandate Trade Union, National Women's Council of Ireland, Youth Council of Ireland, Irish National Organisation of the Unemployed, Forsa Trade Union, Social Justice Ireland and the Pensions Council.

In addition, on 20th and 21st September 2018 the PPRG hosted an international pensions conference in NUI Galway (PPRG host ENRSP conference). With 20 academic and policy papers covering various aspects of pension systems and pension reform from across the EU, and the USA, the current issues emerging from a diversity of pension systems were identified and debated in a comparative context. This submission reflects discussions at both these recent events and also draws on the accumulated research and policy discussion in PPRG work since its foundation.

In this document, the PPRG does not presume to fully represent the considered views of its members and seminar participants on pension policy as a whole – or on AE. With the expressed agreement of the recent seminar participants, PPRG sets out here to summarise their concerns and questions about the proposed AE scheme. As the document makes clear, these concerns and questions range from fundamental issues about AE as a second-tier pension regime, to potential problems in relation to specific groups (for example, women), to quite discrete 'technical' issues (for example, transferability of PRSAs to new AE schemes, or the cost of the proposed central collection agency). The submission, therefore, is a systematic record of the questions and problems raised by participants in PPRG research and discussions and is not offered as a complete analytical commentary on the proposed AE scheme and its rationale.

In the reminder of this document some of the content is identified and expressed in terms of sub-headings with specific recommendations. Other content is more discursive and raises questions and issues that are not translated into concrete recommendations.

The parameters of the consultation document

It is correct that policy-makers should not be complacent about the real costs of ageing for pension systems. The Automatic Enrolment Programme Management team at the DEASP are to be congratulated on the extent of their groundwork and research on pensions, evident in both the public consultation document and the regional consultation fora. However, we question the way the parameters for consultation have been determined, as they effectively take key questions off the reform agenda. Consequently, fundamental reform decisions do not form part of the consultation. The key issue we raise in this regard is the elimination of a larger role for the state within the pension system.

The idea of a funded, privately managed, second-tier to Ireland's pension system is not new. In 1993, the National Pensions Board's (NPB) *Final Report* recommended that "the coverage of occupational pensions and personal pension arrangements on a voluntary basis should continue to be encouraged, in particular the existing tax treatment should be maintained" (p. 202). This recommendation reflected a switch away from the idea of strengthening the state pension with an earnings related tier, as articulated in the *Green Paper on a National Income Related Pension Scheme* (1976), to strengthening the role of private pensions in the national pension system.

The NPB justified their recommendation by arguing that it would recognise 'demographic and social developments and the changes in labour force participation and employment patterns' (ibid. p.7). Moreover, it also took account of 'concern that the overall level of pension provision should not impose an undue burden on the economy as a whole and that any improvement should not jeopardise overall competiveness, growth and employment through increased taxation or social insurance contributions' (ibid., p. 8). In making this recommendation, the NPB was reflecting the developing trend of retreat from public insurance as a response to the risks of ageing, most notably promoted by the World Bank in its influential 1994 publication *Averting the Old Age Crisis.*

The National Pension Policy Initiative (1997-1998) continued the momentum in favour of private pensions as the preferred policy trajectory. In *Securing Retirement Income* (1998), the NPB recommended the introduction of Personal Retirement Savings Accounts (PRSAs) to further encourage voluntary private pension savings. The failure of PRSAs and voluntary private pensions to substantially improve second-tier pensions coverage or to alleviate a future over-reliance on public pensions prompted the *National Pensions Review* (2005), the *Special Savings for Retirement* report (2006), and the *Green Paper on Pensions* (2007). These exercises were followed by a further round of consultations, the feedback from which was reported in *Report of the Consultation Process for the Green Paper on Pensions* (2008). In the foreword to this document the (then) Minister noted that there were 'many and varied views' on future policy and that 'there was no overall consensus' about future reforms (2008:4). It is striking that in the acknowledged absence of consensus on the future shape of the pension system, DEASP published the National Pensions Strategy (NPS) two years later and proceeded to implement it. AE - one element in the

NPS – is not, therefore, a strategy that arose naturally from the views, demands and preferences expressed in the debates and consultations about pension strategy.

As the idea of a stronger role for private pensions in the Irish pension system becomes increasingly entrenched with every report recommending it, there has been a notable gap in the supporting argument. No empirical evidence or projections exist to support the idea that commercial organisations are better at delivering pensions that non-commercial ones. Also required to support private pensions is an examination of efficiency and effectiveness of the tax expenditures on private pensions and the regulatory costs so that a valid comparison could be made on whether the public or private parts of the system offer the state the best value for money.

The Strawman document removes from the agenda any examination of these decades-long ideas underpinning the policy recommendation. This is despite the costs and distribution of the tax expenditure on pensions being expensively problematic (Collins and Hughes, 2017), and the European Union's recognition of partial funding alternatives such the Finnish reforms as a model for a sustainable European pension solution (European Commission, 2017).

PPRG accepts that AE is an attempt to finally construct a comprehensive second-tier in Ireland and considers it important to comment on the specific proposals in the Strawman document. The remainder of this document comments on a range of specific issues that arise in implementing the version of AE in the Strawman.

Gender

It is widely acknowledged that gender inequality in employment patterns transforms into gender differences in coverage of occupational and private schemes, which are more likely to be used by men and people in higher paid employment. Women workers' decision making around retirement is increasingly important given the increasing involvement of older women in paid employment. Nevertheless, most policy reforms adapt a one-size-fits-all approach based on the assumption that work is freely available, women are able and healthy to be employed and they can earn sufficient income in order to contribute to a pension. Unfortunately, these norms do not hold for many women. The first point to be noted is that AE - as a systemic addition to the pension regime overall - is one that strengthens the link between employment and pension outcomes; by definition, this reform is the one least likely to narrow the gender gap in pension coverage and incomes.

The proposed introduction of AE to be rolled out in Ireland by 2022 may address the issue of low enrolment of workers in occupational pension schemes and potentially increase participation in workplace-based pension schemes. The UK government initiated a similar policy in 2012 where employers were required to automatically enrol eligible employees into an occupational pension scheme, which has seen increase in overall coverage rates in the UK. But UK's current AE has gaps in coverage, in particular for those in low paid jobs (disproportionately women) and younger workers. This experience of lower coverage among the low-paid has a gender dimension, because of the higher incidence of low pay among women.

A major disadvantage of the proposed A-E workplace pension scheme for mothers is that, unlike state pensions, it offers no credits for episodes of unpaid care work. In some countries, pension systems have integrated features to account for unpaid caregiving, e.g. in France, a certain amount of time relating to childbirth is attributed to the (childbearing) mother and pension entitlements are gathered by child-minding parents if they reduce working hours or stop working. Similarly, even when people have access to auto-enrolment it is unclear whether people will gain out of saving into auto-enrolment schemes.

Women contributors who opt-in to the AE will be far more likely to interrupt their employment for maternity leave, child care and other caring duties; these episodes of non-employment may be multiple and for extended periods. The Strawman proposals allow for the contributions to go 'on hold' and for employees to resume contributions. However, charges will still apply to the accumulated fund during the 'on hold' period, and if women's funds are small the value of their fund will be partially eroded by charges.

Target membership

The Strawman proposes the following in relation to target membership to be automatically enrolled:

- An age threshold for current and new employees aged between 23 and 60 years
- An income threshold of €20,000 or above
- No employee waiting period before enrolment

The following cohorts will be provided an opt-in mechanism:

- Those outside of the age threshold and below the income threshold
- The self-employed

The Government is seeking advice about providing a mechanism to automatically enrol people outside of the paid workforce.

Employees who are members of an existing pension scheme or a contract that meets prescribed minimum standards and contribution levels are excluded from AE.

Waiting period

Eliminating the waiting period for all employees, regardless of their pension arrangements, should improve pension coverage and adequacy.

Removing the waiting period should improve pension adequacy for those who work under temporary contracts. Six-month or 1-year eligibility requirements that form part of most occupational pension plans means that many employees working under temporary contracts do not benefit from employer contributions. The proposal to enroll employees without a waiting period is welcome because retirement savings will accumulate based on personal, employer and government contributions whenever an individual is employed.

Removing the waiting period will also prevent 'income cliffs' encouraging employees to maintain pension plan membership. The conventional thinking is that 'you don't miss what you never had'. If employees are immediately enrolled into the pension plan they will adjust their lifestyle to their income. If pension contributions begin six months or one year later, employees must reduce their spending. Therefore, it seems likely that immediate enrolment will result in less employees 'opting-out' of their pension arrangements.

There are very few investments that will earn the same return as a pension in the years before retirement. The high opt-out rate in the UK will not necessarily be replicated here if employees 60 years or over understand the benefits of employer and government contributions. Employees should be automatically enrolled unless they are within 2 years of qualifying for the state pension.

Thresholds

Age and income thresholds will reduce the opportunities for employees to save for retirement and potentially lead to 'income cliffs'. Combined, thresholds will potentially reduce pension coverage and adequacy.

Working ages reflect occupational choices. While churn may be greater for younger employees, there are some occupations (construction, cleaning, caring, retail) where people are employed at a young age and retire at a young age by choice or due to health issues. While the proposal suggests that individuals outside of the age threshold can voluntarily 'opt-in', those under 23 are unlikely to avail of this option. Enrolment at the age of 23 will limit the period of saving, disadvantaging those who retire early.

The combination of age and earnings thresholds could influence behaviour of both employers and employees. When fully implemented, an employer could reduce labour costs by 6% if they hire employees aged younger than 23 and/or restrict pay to just below the earnings threshold. It is unclear if a mechanism exists so that employees in part-time employment whose combined earnings are greater than the income threshold are automatically enrolled by their employers. Employees may limit their annual earnings to under the earnings threshold to avoid contributing through AE.

The minimum age threshold will lead to an income cliff that will become more obvious when AE is fully implemented. Upon reaching the age of 23, the income of an employee earning over the earnings threshold, will be reduced by 6%. The earnings threshold could also have a perverse effect due to the income cliff. Upon gaining a small increase that places earnings above the threshold, an employee may find that their take-home pay is significantly reduced due to AE. It could take years and a number of pay increases for the take-home pay to recover. The significant decrease in take-home pay for individuals on relatively low incomes, may encourage them to 'opt-out' when given the opportunity.

The ability to 'opt-in' for people outside of the age and income thresholds is not a good option. First, there is considerable research that indicates that inertia will prevail, one of the main reasons for implementing AE. Second, employees may reluctant to ask their employer to enrol them because this will require a 6% employer contribution.

Opt-in mechanism for the self-employed

Pension coverage is low for the self-employed. However, this is not a homogenous group. Some workers are required by employing organisations to operate as sole traders to avoid employment costs, including pension contributions. Others are self-employed as a choice. While mechanisms should be found to promote pension member for the self-employed, the opportunity to 'opt-in' to AE is unlikely to lead to improved pension coverage and pension adequacy.

Opt-in mechanisms for people outside of the workforce

Earnings from employees and contributions from employers are the basis of AE contributions. It is difficult to see how to incorporate people outside of the workforce into a pension plan based on earnings. Most people outside of the workforce do not have the resources to put into a pension plan. The small percentage of people outside of the workforce who do have sufficient resources to save for retirement, probably have other investment options.

Points for clarification

It is unclear how AE will affect organisations with occupational pension plans or with PRSA arrangements featuring regular employer contributions. Will employers with schemes that do not meet the prescribed minimum standards be given the option to upgrade their schemes rather than availing of the AE plan?

Some occupational pension plans are voluntary, requiring employees to 'opt-in'. It is unclear from the Strawman document how employees who qualify but have not joined their company's occupational pension plan will be managed. Will companies be required to enroll non-members through either their existing pension plan, through AE, or will employers be given a choice?

In the Strawman proposal, it states, 'Existing customers of pension providers will not be enrolled in the AE system (but may opt-in if they so choose)' (p. 13). Does this mean that AE will be a pension option for current members of an occupational pension plan?

Recommendations

All pension arrangements (occupation, personal or AE) for employees should incorporate the provision for immediate enrolment.

There should be no age or earnings thresholds because:

- both can lead to unintended labour market consequences based on behavioural adjustments of employers and employees attempting to avoid AE;
- income cliffs could lead to opt-outs as AE, when fully implemented, will cause a sudden 6% reduction in income for those on low-pay; and
- both inertia and reluctance to ask their employer to enrol them may discourage workers from outside of the age and earnings thresholds to 'opt-in' even if they are legally entitled to do so.

Government should consider a gradual introduction to AE for those on low pay increasing by 1% for each €1000 income increment with full contributions at the minimum wage. (See Table1 below.)

Table1; Pension Contribution rates

Earnings	Pension contribution
Minimum wage - €5000	1%
Minimum wage - €4000	2%
Minimum wage - €3000	3%
Minimum wage - €2000	4%
Minimum wage - €1000	5%
Minimum wage	6%

Suitable arrangements for the heterogeneous self-employed should be found that will provide a stronger incentive than the ability to opt-in to AE.

It is unnecessary to find a mechanism to AE people outside of the workforce. It would be difficult to implement through existing or proposed structures because AE is based on employee earnings and employer contributions. It is likely to be attractive to people with significant resources to invest while outside of the workforce. This cohort can find other investment options for their surplus resources.

Existing workplace pension plans, whether occupational or personal, should be upgraded if they do not meet the prescribed minimum standards of AE.

Employees of companies with pension plans that feature regular employer contributions, who have not joined, should be automatically enrolled.

The criterion for AE participation should be clearly identified, particularly as they relate to employers with existing pension plans.

Employer/ Employee Contribution Rates

As far back as 2015 the Small Firms Association (SFA) has made it clear that it was opposed to a mandatory pension system. The SFA refers to the emerging AE strategy as 'mandatory' but clearly its concern is on the likely cost impact of the AE proposals.

'It is clear that the current pension provision needs to be enhanced to meet the demands of future retirees but we are by no means convinced that mandatory pension provision is the best option. Mandatory pension provision will prove costly to employees, to business and to the Exchequer, without any associated benefits in the long term. As such, the willingness of both employees and employers to accept compulsory pension savings is seriously questionable.

With the economic recovery slow to be felt by small businesses, many are still struggling to keep their doors open. In this context, where cost control and reduction remain critical for small businesses, it is unacceptable to impose an increase in the cost of employment. Any direct contribution obligations on employers will simply add to the already high cost base, where labour costs are running at 121% of the EU average. Moreover, employers will be faced with demands for compensation by employees for any apparent reduction in their real take-home pay. These employees already have little disposable income due to our current high income tax / PRSI / USC regime, and very high mortgage variable rates and childcare costs.' (SFA Press Release Monday 25 May 2015)

A key target population for AE are low earners in small employers. In businesses who do not have a pension scheme already in place, a mandatory 6% contribution levy on both the employee and the employer is a significant reduction in take home pay for a low earner and an expensive addition to total labour costs for small and medium size SME's. For businesses which already has a scheme in place, there are also considerations. Negative consequences which could ensue include the following;

- Proactive encouragement to opt out (see below).
- Changes in contract terms and conditions so as to fall outside the remit of AE – salary less than 20k, split contracts, increases in part -time rather than permanent contracts.
- Drop in take home pay of low earners reduces incentive to work.
- Employers may dumb down superior DC occupational pensions to match AE terms.
- There is nothing in the strawman to suggest that employers with schemes on contribution rates less than the AE rates will be obliged to increase contribution rates.
- AE will reduce spending power of low earners, this may increase pressure on charitable organisations to make good the short fall.

Opt Out Policy

Section 4.6 of the Strawman proposals sets out the policy for opt-out and re-enrolment. In this regard the PPRG would like to make the following observations;

- Compulsory contributions for employees in financial difficulty just adds to their stress and difficulties and serves no positive purpose if said employees have no real choice financially but to opt out in month 7.
- The two month window may be harsh for employees who are overwhelmed with financial difficulties.
- The 6 month compulsory contribution may lead to contracts with lower salaries in the first 6 months to reduce contributions prior to opt out in month 7.
- Employers may actively encourage new employees to opt out.
- There is no detail in the Strawman as to what criteria is necessary to qualify for a "saving suspension". Will employer contributions also be suspended?
- It is not clear whether employees who work for an employer with a voluntary scheme but who have opted not to join it will be automatically enrolled onto their employer scheme or can continued to remain un-pensioned.

Investment options

The Strawman proposal suggests that:

- Funds will operate on a DC basis
- The CPA will be responsible for sourcing, via open tender, a maximum of four Registered Providers
- Each Registered Provider will offer three 'standard' investment options at three levels of risk (possibly low, moderate and medium)
- All options will incorporate either a lifestyle or target date approach defined by the levels of risk
- A default fund will be identified by each Registered Provider for those who cannot decide between funds
- Members will be allowed to transfer between providers and options
- Management fees will be capped at annual charge of 0.5% of assets under management

DC Funds

The Government should reconsider automatically enrolling employees into a DC-type scheme. Research suggests that most people are unable to make reasoned, risky decisions that result in adequate retirement incomes.

There are many features of DC plans. However, the one that is not adequately addressed in the Strawman proposal is the risk incurred by the pension plan member. This is an issue for all DC plans, whether AE to a state-supported, personal or occupational pension plan.

Empirical research suggests that individuals do not make good financial decisions, in part because they are unable to evaluate risk. Kahneman and Tversky (1986) found that individuals are risk averse in the sense that they prefer positive certainty rather than positive probability. However, they are risk seeking in preferring the probability of a loss rather than the certainty of loss. In relation to pensions, this means that risk-averse individuals tend to choose a 'safe' investment option, being more concerned about the possibility of short-term losses than the potential of long-term gains that can be earned by investing in higher risk investment options. If faced with reduced saving close to retirement due to market downturns, they may be tempted to invest in risky assets rather than consolidating their savings.

There is a significant body of research suggesting individuals are irrational when confronted with risky pension decisions. Pension plan members remain in an investment fund although other choices featuring higher rates of return are available and switching costs are low (O'Donoghue and Rabin, 1998). Benartzi and Thaler (2007) described the behaviour of new pension plan members stating, 'The market timing of new participants in their exposure to equities was exactly wrong. They bought high and sold low.' Given a choice, employees chose to invest in their own company's stock although the risk was greater and the expected return was less (Blanchett 2013;

Benzarti et al 2007). Other research suggests that pension members' preferences are inconsistent. When pension plan members were asked to compare three un-labelled investment fund options that included their current choice, the majority chose a different fund. Benzarti and Thaler (2002) speculated that an explanation for these inconsistent preferences is that investor preferences are not stable and well-defined. They concluded that giving pension savers choice does not necessarily increase either their utility or their retirement income. Finally, people's financial behaviour is easily changed and subject to manipulation when choices are framed differently (Willis, 2013).

As discussed above, the 'target membership' for AE are currently the un-pensioned. Maloney and McCarthy (2017a) characterize the un-pensioned as the young, less educated, lower income, part-time employees and those with weak labour market attachments. They also note that, 'The un-pensioned component of the workforce is mainly comprised of the employees of many small employers. In 2012, over 98 per cent of Irish firms had less than 50 employees; approximately 75 per cent of the employees of small organisations were not members of employer-sponsored pension plans in Ireland' (Maloney and McCarthy 2017b).

Automatic enrolment, automatic escalation and default investment funds are behavioural economic policies embraced by policy makers and are features of the Strawman proposal. However, the un-pensioned are individuals who are more likely to save in a credit union than the stock market. They are unlikely to understand the risks associated with investment fund options. Although it clear that individuals do not make good investment decisions, the AE pension plan members will be responsible for investment choices involving risk and uncertainty that they do not understand.

Recommendation

It would be preferable to automatically enroll employees into a government run, risk-sharing investment fund even though their retirement income will be potentially less than in a DC scheme.

Registered providers and investment options

Twelve investment funds provided by four pension providers is too many. The reason for selecting a maximum of four Registered Providers is not clear from the Strawman proposal. However, an official explanation given in an information session about AE is that, based on experience from New Zealand and Australia, about 100,000 members are needed to make a pension plan profitable for the pension provider, at a low cost for individuals. The Government estimates a target population of 410,000, based on the salary and age thresholds discussed above. The Strawman proposal suggests that each pension provider offers three 'standard choice' fund options that are either lifestyle or target date funds. Therefore, the automatically enrolled will have to choose from 12 lifestyle or target date options at three levels of risk, with different compositions of assets. As proposed, four options will be targeted at the same risk level and probably have similar asset compositions.

Research by Lunn et al (2016) suggests it is difficult for individuals to identify a good product even if the factors for making the decision are limited. They state that 'a product might be considered 'complex' once consumers must take into account more than two or three factors simultaneously in order to judge whether a deal is good or bad' (Lunn et al, 2016, p. xii). In the case of pension funds, 'good' or 'bad' will be determined in the future. There will probably be little difference in the fees charged for the investment fund options which will be capped by legislation eliminating price as a factor that members can compare. Simon (1983) discussed the cognitive and numerical limitations of decision makers. However, the amount of choice in the Strawman proposal appears to be beyond the limited capacity of the most people including the un-pensioned.

If the recommendation above to enroll in a government-run, risk-sharing scheme is NOT accepted, the state should:

- Adopt as a principle that the structure and communication of pension plans is understandable to a person with a leaving cert education.
- Reduce the number of investment funds to three clearly differentiated investment options.
- Ensure that the communication about investment options compares the options on two or three relevant factors.

Default fund and other investment fund choices

The Strawman proposal for the lifestyle or target date fund as the default requires more research. A low-risk, low-fund option is needed. Even with improvement to the default and investment fund choices, it is unlikely that pension plan members will have the knowledge or confidence to change investment fund options appropriately.

There is substantial evidence accumulated over many years that pension plan members will either choose the default investment fund option or be placed into the default if they are unable or unwilling to make a reasoned choice (Madrian and Shea, 2001; Vanguard 2015). The research conducted by Choi *et al* (2004) and Beshears et al (2010) found that low-income members of occupational pension plans are the most susceptible to remaining in defaults. Beshears *et al* (2010, p. 9) suggested this is because they have, 'little confidence in their ability to choose an appropriate asset allocation'.

The Strawman proposal suggests that all options will incorporate either a lifestyle or target date approach defined by the levels of risk (low, moderate, medium). Both approaches are similar. When pension plan members are younger, their savings are invested in riskier assets, typically equities. As members age, their savings are moved into less risky assets. Depending on their choice for the pay-out phase, a member's assets will be equity-free (annuity) or partially invested in equities (ARF) at retirement. Ten years before retirement, in most lifestyle or target date approaches, members are heavily invested in equities.

It is likely that the default chosen by the State will be either a moderate or medium risk investment option. The idea of 'choice architecture' is to nudge people into choices that they would make if they had sufficient time and cognitive capacity to make a reasoned choice. If left to their own choice, it is feared that pension plan members may choose low-risk funds that will not grow sufficiently to ensure an adequate income at retirement. In a review of the pension practices of Vanguard, small business pension plan members in the US, Young (2018) found that most firms had a default investment fund, whether enrolment was automatic or voluntary. Ninety-six per cent of the default funds were target date and three-quarters of pension plan members invested all or some of their savings in the default. Therefore, most of the assets of members were invested in equities. Young (2018, p. 25) justifies equities as the dominant investment class stating, "From an investment perspective, an asset allocation of equities of 80% or more may appear appropriate in light of the long-term retirement objectives of most DC plan participants. The default lifestyle strategy in the UK for NEST, features investments in a 'growth fund' with a European Securities and Market Authority (ESMA) risk rating of five on seven-point scale.

The Strawman proposal raises three concerns. Currently, equities comprise a substantial part of the asset allocation up to five years from retirement. (See for example Irish Life Employer PLS or Zurich Pension STAR Investment Strategy.) Although equity investment may be the best choice for savings growth over the long-term, the timing of economic downturns could substantially impact on a pension plan member's total retirement savings. For example, the impact of a financial crisis in retirement savings can be overcome if a member is 30 years from retirement. However, it would be difficult to recover the value of retirement savings for a person 10 years from retirement. No research has been found to date that shows the impact of a financial downturn during the final 10 years before retirement on the savings of pension members in typical lifestyle or target date investment funds.

Second, all of the investment options in the Strawman proposal are lifestyle or target date. Although the proposal suggests that members will be allowed to move assets to different investment funds, the lifestyle and target date approaches are similar. For example, it is difficult to see how choice makes a difference to pension plan members attempting to protect their retirement savings during an economic downturn.

Third, 'low risk' may mean negative growth. Currently, there are few 'safe' options. The combination of very low interest rates on cash and bonds, combined with the costs of pension plans means that retirement savings may be negative at the low end of the ESMA risk rating scale.

This discussion calls into question if a DC-type pension plan is an appropriate choice for automatic enrolment. Even if there is a 'low risk' choice available to the pension plan member to move assets during an economic downturn, the research discussed in the previous section suggests that members who make active choices generally sell when the equity market is low and buy when it is high (Benartzi and Thaler, 2007). However, it is likely that most members will remain in the pension plan default. This raises a difficult issue. While AE may make most people better off, the underlying difficulty for individuals to make complex financial decisions will disadvantage some pension members. The extent and effect of this will depend on the timing of financial crises, events that are completely out of the control of pension plan members, and their inability to determine a correct course of action when facing risk and uncertainty.If the intention of government policy is to take advantage of inertia to promote pension savings, members should in some way be protected from the risk associated with inertia.

Recommendations

- Before a lifestyle or target date approach is chosen as the default investment option, analysis should be undertaken to identify the impact of a financial downturn that occurs close to the retirement date.
- There should be a safe, low-risk, low-cost investment fund option that can be used in the case of an economic downturn.
- There is a serious moral dilemma in allowing choice while recognising from research that cognitively limited individuals are unlikely to use choice to make good financial decisions. During periods of economic downturn, those closest to retirement should be notified to move their funds to a low-risk option until the market recovers.

Arrangements for Benefits and the Pay-out Phase

The arrangements for paying out benefits from AE is in many respects the critical part of AE to get right. Yet it is the least developed part of the Strawman Document. Granted, the first retirees from AE will not materialise for a number of years post commencement. Nevertheless, for AE to be successful and an attractive option to enter, the exit plan must be clear and easy to understand.

As the pension landscape has evolved, the scenario facing those retiring from occupational pensions has changed. Once, the norm was a tax-free lump sum and a defined benefit pension with post retirement increases and an attaching spouse's death-in-retirement pension. Any additional voluntary contributions were generally applied to reduce the amount of pension that needed to be commuted to generate the lump sum. Now, those entering retirement are increasingly doing so from a defined contribution environment. They face an array of choices.

- DC occupational plan members can take a tax-free lump sum based on service and salary of up to a revenue limit of 1.5 times final remuneration, with the balance being applied by the trustees to provide annuities for the member and beneficiaries.
- Alternatively, DC plan members can take a tax-free lump sum of up to 25 per cent of the value of their fund, and invest the balance in an Approved Retirement Fund (ARF).
- The 25 per cent tax-free lump sum also applies to those retiring with a PRSA.
- PRSA holders can also purchase an annuity, and have the added option of retaining the money within the PRSA.
- Annuity purchasers can decide between buying a fixed, deferred, single life or joint life pension; and with or without post-retirement increases.
- ARF investors must satisfy a minimum guaranteed pension amount (including the state pension) to allow the transfer of their retirement pot.
- If they do not satisfy a minimum guaranteed pension amount (including the state pension) they can transfer their money to an approved minimum retirement fund (AMRF) which has restricted access up until age 75.

If this level of complexity is transferred into AE, it will completely undermines the ambition for simplicity. Currently, there are three separate components to pension benefits; a tax-free lump sum, a pension, and a continuing investment in an Approved Retirement Fund (ARF) or an Approved Minimum Retirement Funds (AMRF).

The tax-free lump sum element has always been an anomaly in occupational pensions because individuals receive tax relief on contributions going in to the pension, yet can still avail of a tax-free payment on exit. It also serves to reduce the amount of pension payable and so detracts from arguments supporting the retention of marginal rates of tax relief. In AE, as presently envisaged, contributions are paid from net salary and so it seems reasonable to retain the tax-free lump sum as an option. It also creates consistency between the occupational pension regime and the AE regime.

The Society of Actuaries in Ireland completed a comprehensive review of Approved Retirement Funds vs Annuities in 2015, which set out the pros and cons of each. Their report suggested that some combination of ARFs and annuities is the optimal benefit design. On one hand, this opinion has its merits. Having a compulsory minimum annuity insures against longevity risk. Having an ARF type fund in old age allows flexibility in draw down. The Registered Provider at the point of retirement can be required to offer an ARF type account and facilitate any annuity purchase. The carousel approach of allocating savers to Providers should ensure that each Registered Provider has a fair opportunity to retain the ARF type business of their members. The annual notional distribution taxation measures that currently apply to ARFs should equally apply to a drawdown account created from AE. This will avoid the treatment of the drawdown accounts as a devise for accumulating wealth tax-free to bequeath to heirs, as occurred in the early days of the ARF regime.

On the other hand, the Pensions Authority have flagged the lack of regulation around ARFs and the Pensions Council's research points to how the level of fees charged can, in some instances, reduce or eliminate investment returns[1]. In addition, future increases in the state pension can force pensioners to alter their AMRF to an ARF. This is currently the case following the 2019 budget increases, and as a consequence some pensioners will become liable to tax on a notional draw-down basis.

To develop our response on this point, we return to the reason for AE – to deliver a simple mechanism for accruing future pension income which will reduce an over-reliance on the state pension. The lack of consumer protection, the level of fees, and the sheer complexity of ARFs and AMRFs is at variance with the concepts of simplicity underpinning AE. The less complicated outcome is an annuity-type income, with the tax-free lump sum providing a flexible bulwark against unexpected expenditure.

This of course raises technical questions which are outside the scope of our response to the Strawman Document. These include investment decision-making as retirement approaches to protect the value of the pot, market down-turns which reduce the value of the pot at the point of retirement, and to how best to ensure an annuity market exists that best serves the needs of AE members. In either event, the structure of the final pension payout must be designed very carefully and communicated very clearly if the benefits of an AE scheme are to be obtained.

Taking a gender lens to the benefit and pay-out phase, we repeat our concern that the state (contributory) pension is related to employment based contributions: AE as a supplementary pension also tied to employment will merely serve to reproduce inequality and widen the gender gap in pensions. There are two specific gender related issues we wish to raise in relation to the benefit and pay-out phase. Firstly, the absence of any mechanism for an annuity to revert to a

[1] Department of Finance (2018) *IDPRTG Pension Reform Consultation Paper*

spouse where single life annuities have been purchased will predominantly impact widows. To ascertain the extent, if any, of this problem we recommend that statistics on the type of annuity purchases be analysed to establish the future position of wives who outlive their husbands. Secondly, the benefits emerging from AE will directly relate to the value of the pension pot. In established personal account systems, for example those in Australia and New Zealand, significant superannuation accumulation gaps are evident. A study by Hodgson and Marriott (2013) suggested a number of policy tools to alter outcomes for women. These include:

- Carer support credits as a component of paid maternity, carers, and parental leave.
- Higher matching contributions for low paid workers where women are over-represented.
- Incentives for breadwinners to make contributions to the account of a lower-paid spouse.
- Removing caps on contributions for older women returning to the work force to allow them to catch up on years when contributions were restricted.

Women, especially those who have spent significant periods of time as a homemaker are at particular risk of being at risk of poverty in old age in the event of marriage breakdown. Therefore, we recommend that Pension Adjustment Orders which apportion part of the one spouse’s pension to a former partner equally apply to benefits from AE.

Tax Expenditures and Financial Incentives

The appendices attached reproduce the PPRG's full submission to the Inter-Departmental Group and the detailed empirical paper on the scale and distribution of tax based incentives by two PPRG members (Collins and Hughes, 2017). This document does not, therefore, repeat the statistical details to be found in the appendices. The key statistical findings to note in the appendix materials are as follows (Collins and Hughes, 2017)

*Tax reliefs on employer and employee contributions and associated reliefs (on individual pensions, BIK relief, exemption of capital gains etc.) are considerable (just under 2% of GNP in 2014), have grown significantly over the long-run, and are proportionately more significant than in many other OECD countries.

* The take-up of the tax reliefs is highly skewed by income, and therefore the cash benefits of the reliefs accrue very substantially to the higher income groups, because those on higher incomes are more likely to have supplementary pension coverage and make greater contributions.

*Notwithstanding the cost of the tax incentives, the coverage of the supplementary pension system has remained stubbornly in the range of 50% of the workforce

* The differences between income groups apply not only to coverage rates, but also to contribution rates, with rates for lower income groups inadequate to sustain acceptable replacement rates in retirement.

*The data on income levels and sources of income among the older population show the importance of the state pension in older persons' households and the income gradients for this source of income. Among those in the lowest decile, 65% of pensioners' incomes derives from the state pension, whereas the figure for the highest decile is only 17%. In relation to *pension* income specifically, 90% of the income of pensioners in the lower half of the income distribution derives from state pensions.

Three fundamental conclusions arise from the analysis in the appendices. First, tax reliefs, notwithstanding their costs, have been ineffective in growing voluntary second-tier pension into a comprehensive tier of pensions; therefore, the use of a matching contribution model (rather than marginal tax relief) in the Strawman proposals is to be welcomed as a more effective way of encouraging and retaining enrolment. Second, the distributional impact of the matching contribution system will be fairer than tax-based reliefs. Third, because of the importance of state pensions in pensioner households, any future risk-based second-tier can only contribute significantly to pension adequacy, if the first-tier state pension is fully comprehensive and adequate.

Organisational Issues

The proposal as envisaged is a joint State/private sector scheme, with strict demarcations between what the public sector may do and what the private sector may do. The proposal is that administration would be performed by the State via a Central Processing Unit (CPA), while funds would be managed in the private sector, by AE registered, preferred providers.

The proposal does not discuss the costs of setting up the CPA. There are likely to be large initial costs with significant ongoing costs associated for example, with those entering, discontinuing contributions for a time, or terminating contributions altogether because of emigration. A key policy question, therefore, is: What are the set up costs and the recurring annual costs of the CPU? An equally important consideration is the implicit allocation of costs as between the public and private sectors. The (considerable) set up costs will be met by the state (presumably under the DEASP departmental budget) and the contribution income will then be assigned to the for-profit, preferred providers to manage. There is no explicit rationale in the Strawman for this arrangement, and no reference to the fact that DEASP already administers and manages a central collection agency for contributions: the Social Insurance Fund.

As regards the cost of administering the CPA, the Strawman does not reflect the cost and complexity of the proposed arrangements. It does not refer to these practical, cost-related problems and complexities in the proposed scheme.

Lost accounts

Changes in members' circumstances can result in what are termed lost accounts; these changes include changes in address, migration, mortality, etc. In Australia there were 6.2 million 'lost accounts in June 2018 with Aus. $ 17.5 billion in funds (Source: https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Super-statistics/Super-accounts-data/Super-accounts-data-overview/). The identification and management of such lost funds will be complex and costly.

Multiple plans

A problem that has emerged with the Australian pension system (compulsory) is that frequent job changers end up with multiple pension plans (referred to as 'unintended multiples'), often with small amounts in each plan, with consequently higher charges (https://www.pc.gov.au/__data/assets/pdf_file/0003/228171/superannuation-assessment-draft.pdf, p. 17). Similar issues may arise with the proposed AE. The issue of multiple pension plans may be compounded because some new members of the proposed AE scheme may be members of a PRSA. An employee with a work history with previous employers may also have accumulated pension entitlements from each employer, including perhaps entitlements in different countries. Multiple pension entitlements means costs are much higher than for a single pension plan. The identification and management of these multiple funds will be costly and complex

The problem of 'Churn'

Churn refers the incidence of people entering and leaving schemes and switching schemes. New Zealand's experience of AE shows that churn can be high, as Table 2 below shows. A high incidence of churning is inherently a problem; for example, it leads to non-contributions, administrative costs for re-entry. Monitoring of multiple plans, and so on. The Strawman proposals are silent about how the costs of administration can be minimised because of churn, and do not address other practical issues. For example, will the funds of discontinued members be subject to an administrative charge? Will there be any exit and subsequent re-entry charges, and if so, what impact would such charges have on participation and re-enrolment?

Table (2): Total members, non-contributory members and churn

	members	Not contributing[3] per cent	Member entries[1]	Temp and per. exits[2]
March 2017	2.7	42.2	521735	443273
March 2016	2.6	42.7	519239	454382
March 2015	2.5	42.6	725995	574038
March 2014	2.29	44.5	997923	846015
March 2013	2.09	46.0	474895	401206
March 2012	1.91	45.0	625630	504059
March 2011	1.67	44.5	587227	477105
March 2010	1.37	44.3	560685	505618

Source: *Financial Markets Authority, Kiwisaver Annual Reports*. Data collection and administration is by Inland Revenue, New Zealand.

Notes;

(1) Mostly consisting of new members, members transferring from one Kiwi saving scheme to another and members restarting contributions.

(2) Mostly consisting of transfers out to other Kiwi savings schemes, and members stopping contributions.

(3) Non-contributing members are those who have not made a contribution in the previous two months, those who have failed to make contracted payments, and those on a contributions holiday.

Confidentiality

The Strawman document does not allude to the issues relating to confidentiality in managing participants' access to accounts. The document envisages the following:

* 'A web-based CPA Portal will allow employees, and other members, to access and select from the available saving scheme options" (Strawman, p. 5); and the portal 'will provide front-end information and processing'.

* ‘Employers will have to enroll employees and organise the transfer of contributions to the CPA’. (p. 8);

* ‘Registered Providers must deliver services to all of those eligible for Automatic Enrolment including those who can opt-in to the system’ (p. 5).

Maintaining a confidential, yet accessible service across four domains - CPU, members, employers, and service providers will be challenging. This may be particularly acute given the likely relatively low income nature of many potential members with possibly limited access to computers and internet services.

The Strawman Proposal also refers to support ‘for employers in delivering on their duties in the roll-out of AE’. Complex issues will arise regarding the eligibility criteria for employees, for example period of employment, number of hours of work, the main employer in cases of multiple employments, membership of existing schemes, and so on. The international experience suggests that employers will be required to interpret and implement highly complex rules and guidelines at the roll-out and later phases

The document refers to supports as distinct from ‘information’ for members. However, the document does not specify whose role it is to provide supports for those who are unemployed, and/or no longer contributing to, or resident in the State.

Property Rights

The proposal envisages that ‘each member would be able to take their account or ‘retirement pot’ when they move jobs’. AE schemes in other countries - for example in New Zealand - regard pension contributions (employer and employee) as a property right. In New Zealand funds may be drawn down for house purchase, and financial hardship.

Pension contributions in an AE will become a property right, with associated inheritance rights, as in the case of an ARF. The Strawman Proposal (p. 6) states that members will be able to draw down ‘funds as a lump sum’. This is in strict contrast to the State Old age Pension, or pensions provided in the form of an annuity, and is one of the reasons why PAYG pensions systems are less costly than funded systems. This problem raises the issue alluded to earlier; the desirability of annuity-based pensions in the pay-out arrangements

Because pension contributions (plus returns) constitute a property right, which may last over several decades, governance requirements are much higher than for other forms of financial contract, and raise a further level of complexity. For this reason, pension funds are most often managed as Trusts, although some may be managed as contracts. Higher governance standards also mean greater regulation. So that in most countries there is a pensions regulator. Funded pensions require far greater regulation than unfunded or PAYG Pensions.

Governance, Regulation and related issues

Governance issues are now regarded as a key component of pension provision. In particular, it is widely recognised that costs affect returns and eventual pension payments. Risk is also important, particularly so in recent years (post 2000) because of volatility in share prices and stock market returns. The Strawman document does not address the fundamental question of how to minimize risks and costs; this is especially important because the risks - as currently envisaged – fall on the individual retirees.

Regulation

The market for pensions is far removed from what might be termed a 'perfect market'. Because of considerable market 'imperfections' - asymmetries in information, dominant market providers – and fundamental uncertainty, pension provision tends to be highly regulated.

There is a widely recognised need that conflicts or potential conflicts of interest should be avoided. This may be difficult. Hence a more recent emphasis on disclosure and transparency.

The Strawman document claims that the AE scheme 'will make it make it easy for participants to understand and use'. However, it is clear that the level of complexity of the scheme and its administrative and regulatory complications imply that the AE scheme may actually be difficult for employees and employees to use and understand.

Existing employer DC pension contributions.

The AE scheme will add to the existing suite of second-tier pensions such as PRSAs and DC schemes. An important consideration, therefore is whether AE will displace contributions to existing pensions. There is some evidence that DC contribution rates in the UK (already low) have fallen in recent years as the UK's auto-enrolment scheme was being implemented (Table 3).

In the UK the average employee contribution rate in the private sector decreased from 3.1 per cent in 2012 to 1.3 per cent in 2016. Similarly, the average employer contribution rate in the private sector decreased from 6.6 per cent in 2012 to 2.1 per cent in 2017. The data also shows that amounts saved per eligible saver are low and falling through time.

Table (3) DC Contribution rates in the UK

	2012	2013	2014	2015	2016	2017
Average contribution to DC schemes[1]	9.7 (6.6%)	9.1 (6.1%)	4.7 % (2.9%)	4% (2.5%)	4.2% (3.2%)	3.4% (2.1%)
Average contribution to DB schemes%[1]	20.1 (15.2)	20.6 (5.2)	20.9 (15.8)	21.2% (16.2)	22.7% (16.9)	19.2 6%
Amount saved per 'eligible saver" [2]	£7000	£6957	£6653	£5774	£5419	

(1). Based on pensionable earnings, private sector only. ONS 2016, *Occupational Pension Schemes Survey* various issues. Employer contribution is in brackets.
(2) DWP *Automatic Enrollment Report*, 2016, Table 3.1.

Part of the reason for the fall in contribution rates may be new members contributing at lower rates to AE schemes. However, it is also likely that introducing lower contribution rates for employer AE schemes has also resulted in employers switching to lower cost AE schemes, or reducing employer contribution levels to those of AE schemes. This emerging trend in the UK highlights the risk that the Strawman's proposal for Ireland will affect participation in, and contributions to existing second-tier pensions.

Overview and Conclusions

This section first briefly reviews some key problems and recommendations in relation to the detailed Strawman proposals. Second it raises wider policy arguments that PPRG considers relevant to the specific proposals in *Strawman.* Third, it notes a possible alternative model of supplementary pension that merits fuller consideration.

Problems and Recommendations

The commentary on the Strawman proposals raise many, quite specific questions across a wide range of topics such as membership, contribution rates, investment choice, organizational issues, and so on. It is relevant at this point to highlight some of the key points.

*In relation to membership, the proposed combination of various thresholds, waiting periods, definitions of employment, etc. may exclude some categories. Structurally, it is difficult to see how gender differences in unequal pension participation and outcomes can be mitigated; in fact, they may be exacerbated.

* The proposed contribution rates will add to employers' labour costs and in particular to those of small employers who at present are less likely to have any form of supplementary pension provision. The proposed employee contribution rates will affect disposable earnings and interact with the tax, PRSI and other deductions from gross pay.

* The AE contributions for employers and employees may displace participation in and contributions to existing DC and other supplementary schemes.

* The use of a direct government contribution rather than tax relief at the marginal rate on contributions would be appropriate.

* The use of multiple preferred providers and investment options will add complexity and confusion rather than informed choice. This may lead to 'incorrect choice' among savers and the consequences of this will fall on individuals.

* The long-run return on investments is uncertain - even for participants with the presumed levels of financial knowledge and judgement – and the investment strategy should focus on low-risk investments

* There are complex and technical decisions to be made about the pay-out of the eventual AE pension 'pot'- whether in the form of annuities, lump sums, conversion to ARFs etc. If an AE scheme is intended to yield a *pension,* then annuities should perhaps have a role. This question is made especially complex by the pre-existence of DCs, ARFs and other supplementary provisions.

* The proposed AE scheme does not seem to acknowledge the inherent administrative complexity of what is proposed; international experience suggest considerable administrative costs arising

from a range of problems; monitoring multiple plans, tracking periods of opt-out, migration, lost accounts, property rights and inheritance issues, disputes about participation, among others.

*The proposed CPA organisation is difficult to rationalize on cost and other grounds; there is no reason why the existing social insurance system cannot be developed to collect and disburse any national supplementary pension based on a separate stream of contributions.

Pension Policy

In the view of the PPRG there are five fundamental considerations that should be recalled before proceeding to implement AE along the lines proposed. First, on efficiency grounds funding is *not* inherently superior to pay-as-you-go (PAYG) as a model of pension financing; this is the net implication of the vast theoretical and empirical literature on the topic. Equally important, if funding models were chosen wholly on the basis of equity considerations, then both theoretical and empirical considerations emphatically point to PAYG rather than funding and individualized risk (Barr, 1998). Nor is funding a solution to the financing problems posed by ageing. Against that background, it is striking the extent to which the AE proposals (and their source documents such as the NPF) presume the superiority of funding as an overall model.

Second, the AE proposals are not intended to specifically respond to the demographic ageing of Ireland's population, but the overall thrust of policy (for example, in the Green Paper and the NPF) has been conditioned by a narrative of ageing and its associated impact. PPRG, of course, acknowledges the projected ageing of Ireland's population into the present century. However, it is important to stress that this trend has affected Ireland far later than many European countries and that the trend in Ireland is far more gradual, as comparative analyses of Ireland's demographic dynamics show (Ainsaar and Rootalu, 2016). Therefore, Irish policy makers should be extremely cautious about rationalizing a policy for the very long-term on the basis of a typically 'European' experience (for example, France and Germany) of demographic decline triggered by ageing and falling fertility.

Third, contributors to PPRG discussions and research have noted how Irish policy (Strawman included) has focused on coverage. Of course, the absence of a comprehensive second-tier is a significant weakness in Ireland's pension system and makes it an outlier in international comparisons. The policy effort to grow the second-tier by broadly voluntarist means is therefore understandable. However, in PPRG's view the emphasis on *coverage* should not obscure the social aspect of pensions and in particular the need for pension *adequacy.* The success of an AE should be judged not on coverage, but on the adequacy of the pensions they eventually deliver especially to those in lower-income groups.

Fourth, whatever the potential of AE (or similar) models to improve pensions it is clear - for example from the OECD's (2013) review – that they require *comprehensive, adequate first-tier pensions* as a foundation, because AE provisions are based on individualised risk. In the present case, AE is being proposed at precisely the juncture when the state pension is being retrenched by means of cumulative increases in the (state) pension age and other changes. Furthermore, the targeted level of the state pension (35% of earnings) is still modest by international standards. PPRG recognizes that there is considerable room for debate about how the first-tier might be developed. The point is that recent policy is pushing the first-tier in the opposite direction required for an AE (or similar) scheme to effectively supplement an adequate basic pension.

Fifth, contributors to PPRG discussions over the past year – including those sympathetic to AE-type provisions – are puzzled by the proposed CPA arrangements. DEASP already has a national, comprehensive, and widely accepted system of collecting employer and employee contributions and assigning these to an earmarked fund: PRSI. The Strawman proposes that the State will fund an undoubtedly expensive, separate institution which will add another layer of administration and complexity for employees, employees and the state. Even within the constraints of an AE system, it remains unclear why this cannot be operated by extending the PRSI arrangements to incorporate the additional, separate contributions as Supplementary Social Insurance – and perhaps named as such.

An alternative

PPRG recognizes the importance of constructing a second-tier for Ireland's pension system. However, it believes that the current proposal is too reliant on a combination of funding and individualized risk for future retirees. Some European countries have introduced reforms that recognize both the limitations of social insurance and the challenge of ageing and sustainability by introducing hybrid reforms with varying combinations of the following:

Stronger or more universal – or guaranteed – state pensions as a foundation;

A mix of both state and private supplementary provision;

Mechanisms of indexing pension age entitlement and/or state pension to measures of long-term sustainability (for example, pension age indexed to life expectancy or pension levels indexed to demographically adjusted measures of national income, etc.)

Public and private management of funds, and freedom to invest in government bonds, thereby retaining a greater degree of PAYG;

Some countries have thus introduced a hybrid second tier pension referred to as a Notional Defined Contribution (NDC) pension system. In authoritative review of the rationale for, and experience of NDC schemes Barr *et al* (2011) stated:

> 'NDC schemes have a range of potential advantages. The system is simple from the point of view of the worker, and the fact that it is administered centrally keeps administrative costs low. Risk is kept low, since an unfunded NDC pension system is not affected by capital market volatility, the main source of risk to funded individual accounts. An NDC system does not require the institutional capacity to manage funded schemes. In addition, saving may be the wrong policy, or people may not want to save. Finally, NDC can be partially funded and can be

the basis for a future move to full funding, so the approach may provide a starting point if financial market turbulence continues'.

Clearly, NDC systems can take a variety of forms, and the urgent task of policy makers in Ireland is to identify a relevant comparator NDC that can be adapted to current Irish circumstances. A particularly relevant example of a policy along broadly NDC lines is the Finnish reform which builds on a comprehensive first-tier. The second-tier is a mix of both public and private institutions and key parameters in the overall system are indexed; the net projected outcome for Finland is a very gradually increasing retirement age, but a stable share of pensions in national income, with a form of adequate pension guarantee as its foundation (Kuivalainen, 2018).

PPRG is not specifically proposing the Finnish reform. The central features of the Strawman are; quasi-compulsory participation; employer and employee contributions; matching state contributions, and; a stream of contribution income to a separate, central fund. If these features are retained, they could be embedded in a wider NDC model that has a stronger first-tier, and a mix of public and private management of risks and investment.

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Appendix 1

PPRG Submission to Interdepartmental Group

[Appendix 2, Paper by Collins and Hughes in separate attachment]

PPRG Submission to the Interdepartmental Pensions Reform and Taxation Group Consultation

19th October 2018

INTRODUCTION

The PPRG welcomes the opportunity to input into the reforms currently being considered by the Interdepartmental Pensions Reform and Taxation Group. Our submission complements submissions which the group has made to the Department of Employment Affairs and Social Protection (DEASP) regarding other aspects of the *Roadmap for Pensions Reform 2018-2023*. It also reflects the expertise of group members who have been involved in researching pensions policy issues, and exploring possible policy reforms, for some time.

We have structured our responses in accordance with the series of questions posed (in bold and italics below) by the consultation document. We have provided replies to those questions where we believe we have input to offer.

SECTION A – SIMPLIFICATION & REFORM

A1. Do you agree that PRSAs, BoBs and RACs largely fulfil the same function for a consumer and that it would be beneficial to simplify the DC contract landscape by prospectively ceasing BoBs and RACs? If not, why?

Yes. The current landscape is overly complex and generally inaccessible for most individuals.

A2. What, if any, positive or negative consequences would you foresee from the prospective cessation of BoBs and RACs? What changes would be required to the legislation governing PRSAs? What transitional measures would be required?

No direct reply. However, we note that BoBs and RACs have been used as a means of managing and reducing income taxation liabilities and would expect that these reform proposals will meet some resistance from groups within the Pensions Industry who wish to retain these tools and methods of income taxation management.

A3. What changes would you recommend to the design of the PRSA product?

This depends on how PRSAs are being used. They were originally envisaged as a simple pension product to be used to improve coverage in the pension system. The PRSA products as developed by the life assurance industry are not simple (Maloney and McCarthy, 2017). Their introduction did little to improve pension adequacy or coverage. Changes to PRSAs should be considered in conjunction with their proposed interface with automatic enrolment (AE). For example, will employers be allowed to offer PRSAs rather than the AE system? If so, the PRSA should be regulated both in terms of structure and communication to ensure that they are 'fit for purpose' for SME owners and unsophisticated pension savers.[2]

A4. In terms of pension vehicle rationalisation, what impact could the introduction of the pan-European Personal Pension Product (PEPP) have?

No reply.

A5. In what ways would consumers benefit or be disadvantaged by the standardisation of minimum and maximum drawdown ages across occupational schemes and personal pension products?

The existence of different maximum and minimum drawdown ages across various pensions products and schemes further adds to the complexity and inaccessibility of the pensions system. Therefore, a standardisation of ages has merit on the basis of simplicity. The current system also complicates the ability of policy makers to explore issues of coverage, adequacy, effectiveness and efficiency within the overall national pensions system (both public and private).

A6. Would harmonising the treatment of employer contributions to occupational schemes and PRSAs be beneficial? How would this be best achieved? Would it result in a shift from single member schemes (and possibly SSAPS?) to PRSAs? How would any change impact the funding incentives for employees/employers?

It is inequitable that the current system treats employer contributions differently. Public policy should not be structured in such a discriminatory way. Therefore, a harmonised approach is necessary and overdue. While there is likely to be some resistance to such reforms, in particular from those associated with occupational pensions schemes, the need for equal treatment of equal contributions outweighs any such arguments.

The current private pensions structure, where there are thousands of single member schemes, is neither efficient nor sustainable. Reforms which reduce the number of such schemes are both inevitable and necessary.

A7. Would harmonising the calculation method for maximum tax-free portion of the retirement lump sum across DC occupational schemes and personal pension products be beneficial? How would this be best achieved? Would it result in a shift away from single member schemes?

It is inequitable that the current system treats the calculation of lump sums differently. Public policy should not be structured in such a discriminatory way. Therefore, a harmonised approach is

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[2] Maloney, M. and McCarthy, A. (2017), "Pension provision by small employers in Ireland: an analysis of Personal Retirement Savings Account (PRSA) using bounded rationality theory", *Irish Journal of Management,* Vol. 36 No. 3, pp. 172-188).

necessary and overdue. While there is likely to be some resistance to such reforms, in particular from those associated with occupational pensions schemes, the need for equal treatment of equal contributions outweighs any such arguments.

The current provisions for tax-free and tax-reduced lump sums are extremely generous when judged against similar schemes in other states, or when compared against average levels of pension savings and average levels of earnings. If there is merit in granting individuals a tax-free or tax-reduced lump sum payment upon retirement, then the state should treat all individuals in the same way. Thresholds should be benchmarked to average earnings levels (for example linked to 100% of average earnings of full-time employees in the year before retirement) and should automatically update in line with increases or decreases in average earnings. Tax relief should also be granted at a single rate of income tax applicable to all individuals rather than at the marginal rate.

We also note that there is a potential new inequity between the planned AE system and existing occupational pensions and PRSAs. AE contributions will come from post income-tax earnings and as such, tax-free lumps sums are a fundamentally different consideration. It is a concern that instead of harmonisation and simplification, the combined outcome of current pension reform plans (across Department of Finance and Department of Employment and Social Protection) will generate added layers of complexity and difference.

A8. Should the rules around the tax treatment of death-in-service benefits between DC occupational schemes and personal pension products be harmonised? How would this be best achieved?

For the purposes of simplicity and accessibility, it is ideal that schemes should be as similar to each other as possible. However, issues related to 'death in service' benefits are associated with employment terms and conditions, and the protection of family living standards, rather than specifically and area of pension/retirement income and we believe these should be considered in that context.

A9. Are there constructive changes that could be made to eliminate inconsistencies in the treatment of DC and DB scheme members?

This is a very complex issue and would deserve a significant exploration and examination of all of the 'constructive changes' that the Department might propose.

SECTION B – COSTS TO THE EXCHEQUER

B1. How should the economic and social benefits of tax relief on pension contributions and investment returns be considered/measured and how do you believe the system of tax relief performs in that context?

The performance of the current private pension system should be judged against the objective of national pensions policy. Essentially, that objective is to provide individuals with an adequate income in retirement. The 2007 *Green Paper on Pensions* summarised the objective of the pensions system as follows:

> *"The overall objective of the pensions system, as outlined above, is to ensure that people have an adequate income in retirement. In relation to Social Welfare pensions, the objective is to provide income and other supports so that pensioners are assured of an adequate basic standard of living. The role of voluntary supplementary pension arrangements is to encourage people to make supplementary pension provision. In this respect, a private pension may supplement the Social Welfare pension as well as other forms of retirement income". (2007:3).*

Despite some deficiencies, which could be easily addressed via a universal pension, the current Social Welfare pension provides an adequate basic income for most individuals in retirement. Retaining that payment at a rate which is benchmarked to average earnings would ensure that the relative income and living standards of recipients would not decrease over time.

The performance of the current suite of private pension tax reliefs should be judged relative to the rates of participation and savings that they induce from earners. In overall terms, the current system:

- costs a large amount of annual tax revenue (revenue forgone);
- succeeds in encouraging well under half of all employees to save anything (as contributions from employers, employees or from individuals) for their pension;
- among those who do save, the contributions are small and likely to lead to small additional income in retirement such that income replacement rates will be low;
- skews the benefits of the tax relief to a very small number of earners who are concentrated at the very top of the income distribution.

A recent paper published by two members of the PPRG examined this issue in detail (see Collins and Hughes, 2017). The paper is included as Appendix 1 of this submission and provides a comprehensive assessment of many of the issues raised in Section B of this consultation. The paper concludes:

> *"…as pillar 1 welfare pensions are the most important source of retirement income for the great majority of pensioners, an objective of policy should be to establish a better balance in the distribution of public resources to focus them on low and middle income earners, who need them most, and significantly reduce tax reliefs for the highest earners, who need them least.*
>
> *Ireland's relatively young demographic profile implies that the immediate policy challenges associated with high old-age dependency ratios are some way off. Ensuring the development of an effective pillar 2 and pillar 3 pension system offers an important route to minimise these. Our analysis provides strong evidence of the need for change in pensions policy if society is to be realistic about adequately pursuing an objective of adequate income for all workers in retirement. As things stand, there remains a considerable need for policy innovation to achieve this." (Collins and Hughes, 2017: 510).*

B2. To the extent that the State's tax expenditure on pensions has not resulted in high coverage rates, what in your view explains this?

It is clear from the available evidence that the current system of tax expenditure on pensions is ineffective in achieving national policy objectives for the pensions system. This is despite the large amount of resources allocated to the sector on a recurring basis. As the analysis cited above shows, the current system induces either no pensions savings, or relatively small amounts of pension savings, from most earners. Despite the generosity of incentives, the volume of resources allocated to this area by the state, the advertising and promotion by companies and Government agencies, the rates of participation and contributions are low. What is clear is that the current system of tax reliefs does not work and this is unlikely to dramatically change as a result of small changes to its structure.

Given the volume of resource involved, there is merit in considering what is the best use of these resources. We believe that policy should comprehensively consider the merits of:

(i) the abolition of all tax reliefs for private pensions and the establishment and funding of an enhanced universal state pension with its rate of weekly payment benchmarked to a proportion of average earnings.

(ii) the abolition of all tax reliefs and the provision of an auto enrolment (AE) like system where individual contributions are matched by state contributions.

Of these, we believe the advantages of the first outweigh that of the second, however we would encourage the group to undertake such an exercise and use that evidence as the basis to fundamentally redesign policy in this area.

B3. What adjustments, if any, could be made to marginal relief to best support the roll-out of automatic enrolment?

It is not credible, from a fiscal and operational perspective, to retain the current marginal relief structures in the context of substantial increases in expenditure to support AE. As Collins and Hughes show (see paper in Appendix 1) the exchequer savings (via less tax relief) from changes to the marginal rate are only substantial when the rate is reduced to the standard rate. Such a change would provide resources that could be reused to encourage savings in other ways. However, the core problem of the current tax relief system remains: at great cost the current system induces a minority of employees to put money into private pensions and among these the contributions are small.

We also stress the necessity for a consistent approach across all aspects of the pension system rather than two different taxation regimes.

B4. What form of financial incentives for supplementary pensions, alternative to existing ones offered by the State, would better encourage lower and middle income earners to save for their retirement?

As part of the OECD's study of financial incentives and retirement savings, a review of existing research on the impact of tax incentives and other policies was undertaken which provides a convenient summary (Payet and Antolin 2017)[3]. The authors point to the inconclusive nature of research in this area. However, they do note some studies providing evidence that low to middle class individuals will respond to tax incentives by increasing their levels of savings. In contrast, high-income individuals tend to reallocate from their existing savings into pensions. Their review identifies that flat rate subsidies, including payments into parents' pensions for each child, have proved successful in Germany at encouraging families with children and low-income households to take out private personal pensions (known as Riester pensions).

The Irish experience with SSIAs and their broad adoption across income levels suggests that this approach was easily understood. According to McHale (2006), p. 36-37, "Interestingly, 28 per cent of subscribers had incomes below €20,000, showing that the scheme was certainly not just availed of by the better off. Moreover, a survey of subscribers by the Bank of Ireland found that 76 per cent of SSIA accounts were held by first-time savers. Recent research by Lunn and McGowan (2018) indicates that research participants did not understand the significance of tax relief or matching arrangements. They state, "In the experiment, a representative sample of adults was incentivised to read and absorb typical information available to scheme members, presented in the simplest and clearest form we could develop. Yet comprehension remained disconcertingly poor. In particular, we found very limited understanding of tax relief and matching contributions, with implications for their effectiveness as incentives" (Lunn and McGowan, 2018, pp. 6-7). In short, the incentive presented as a contribution rather than as tax relief appears to be a better incentive for lower- and middle-income earners.[4]

B5. In evaluating equity in the distribution of the economic and social benefits from this tax expenditure, what factors should be considered?

As noted above, the performance of the system should be judged against national policy objectives for the pension system. The current system is highly inequitable (see Collins and Hughes paper attached in Appendix 1) and the scale of inequity is enhanced by the concentration of contributions among those with the highest incomes. It would be difficult to identify a piece of public policy with such broad objectives that provides such an inequitable outcome.

B6. Should changes be made to the existing tax treatment of pensions in any of the following stages?

- ***Tax treatment of employee contributions***
- ***Tax treatment of employer contributions***

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[3] Payet, S. and P. Antolin (2017) 'The Impact of Tax Incentives and Other Policies on Retirement Savings. A Literature Review.' OECD Working Paper DAT/AS/PEN/WD (2017)2.

[4] McHale, J. (2006) 'Perspectives on Retirement Saving Policies in Ireland' in Callan, T. (ed.) *Budget Perspectives 2008*. Dublin: The Economic and Social Research Institute, pp. 21-46.

Lunn, P. and McGowan, F. (2018) *Supporting decision-making in retirement planning: Do diagrams on pension benefit statements help?* Working Paper 588, Dublin: ERSI.

- ***Tax treatment of growth in pension funds***
- ***Tax treatment of drawdown of pension***

If so, what kind of changes should be introduced and for what reasons?

See answers to the earlier questions. However, we would like to add that the current system should be reformed so that employer contributions to their employees' occupational scheme are subject to the age-related percentage limits and the overall earnings cap.

OTHER POINTS OF RELEVANCE TO THE CONSULTATION

- We understand that the pensions industry will strongly defend the current system of tax reliefs and exemptions, as any beneficiary of direct expenditure or tax expenditure of this scale would be expected to do. However, we believe that the current system is unsustainable given its cost, inefficient outcomes and inequitable outcomes. The same resources could be used in an alternative way to derive a better outcome when judged against the national pensions policy objectives.
- We believe that it is important that the current set of public policy reforms to pensions systems provide an integrated, consistent and easy to understand system. We are concerned that a reform of tax expenditure for private pensions, isolated from the construction of an AE system, might produce two different and incompatible systems. It is a concern that instead of harmonisation and simplification, the combined outcome of current pension reform plans (across Department of Finance and Department of Employment and Social Protection) will generate added layers of complexity and difference. This would further complicate an already complex pensions landscape.
- This submission has not addressed the questions raised under Section C of the consultation regarding ARFs. Our forthcoming submission (due November 4th 2018) to the DEASP consultation on the AE Strawman will have a section on benefits and payouts which will incorporate our views on ARFs.

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