

The Economics of Taxing Pensions

Tax Relief, Efficiency and Equity



Moore McDowell

Economist



- Issues:
- Introduction of a radical universal pension scheme to replace current three tier system. Not being considered here.
- Focus of presentation is on suggested reforms to present system.
- Caps, changes in relief rates.
- “Pensions time bomb” and implications assumed.



Reform Proposals

- 2007 Green Paper reflect a serious misunderstanding of the economics of pension taxation.
- Compounded by an inability to separate efficiency concerns from equity issues.
- COT and GP, supported by other commentators (including TASC), have informed the proposed single rate 33% “relief” on pension contributions.



Pension Saving is Deferred Consumption

- The pension savings decision is a decision to allocate consumption out of income over time.
- This is affected by “time preference” and expected return on savings.
- Taxes affect pension savings by encouraging or discouraging future consumption or present consumption.



Pension Saving is Deferred Consumption

- Taxes affect pensions at three stages: contribution, in-fund, distribution.
- Formally (but imperfectly) the tax structure in Ireland in this context is EET.
- TEE and EET structures are savings neutral. Others discourage saving.
- TEE or EET on savings are in reality “expenditure” taxes rather than “income” taxes.



Tax Structure Effects

- The only way the EET structure can actively encourage pension saving is by lowering the final T relative to the rate at which relief is granted.
- The 33% proposal involves a shift from EET to TET for all paying tax at 41%, most contributions at any point in time, and virtually all contributors at some stage.



Tax Structure Effects

- A qualitative shift from an imperfect expenditure tax structure towards a comprehensive income tax structure
- A disincentive for the bulk of pension contributors to maintain or increase contributions.
- Inconsistent with the argument that those who are **currently** paying into pensions on a voluntary basis are not doing so at a “correct level”.



Tax Structure Effects

- Relief at 33% to taxpayers who pay at 20% is in effect a cash subsidy to low tax payers to start/increase pension contributions.
- EET is replaced by -SET, $-S = 13\%$ of premium.
- Strong ***substitution effect incentive*** to save through a pension.



Tax Structure Effects

- Problem is the income effect on the demand for future consumption.
- Background: at low levels of income the contributory state pension already provides a level of post retirement consumption equal to between 30% and 50% of pre-tax income.
- Even with a cash subsidy increasing future consumption implies reducing current consumption at low consumption levels.



Tax Structure Effects

- For the subsidy to have a significant effect the substitution effect of the change has to dominate the income effect.
- This is unlikely to be the case for low permanent incomes (lower socio-economic households).
- Where it may work is in the case of people with higher expected life-time incomes but currently on lower earnings (e.g., so called “young professionals”).



Tax Structure Effects

- Even for them, the aggregate effect on pension saving is ambiguous: it may encourage starting pension contributions during early working life, but strongly discourages increased contributions later on.
- In short, there is little or no reason to believe that the current tax proposals will sustain, let alone increase, pension provision to meet the “time bomb”.



The equity argument

- Three strands
 - 1: Reliefs are “worth more” to the better off...and represent a higher transfer to these households from taxation than the transfer to lower income households.
 - 2: The current regime permits some tax-payers in effect to accumulate unacceptably low-tax or tax-free wealth to enjoy post retirement courtesy of tax-payers as a whole.
 - 3: The cost: could be better used



The equity argument

- The second can be, and has been, dealt with by setting limits to permitted funding in terms of enjoying tax relief.
- It does not provide a basis for the proposal to limit tax relief for all to 33%.
- The main (first) argument is based on a gross misrepresentation of the underlying reality.

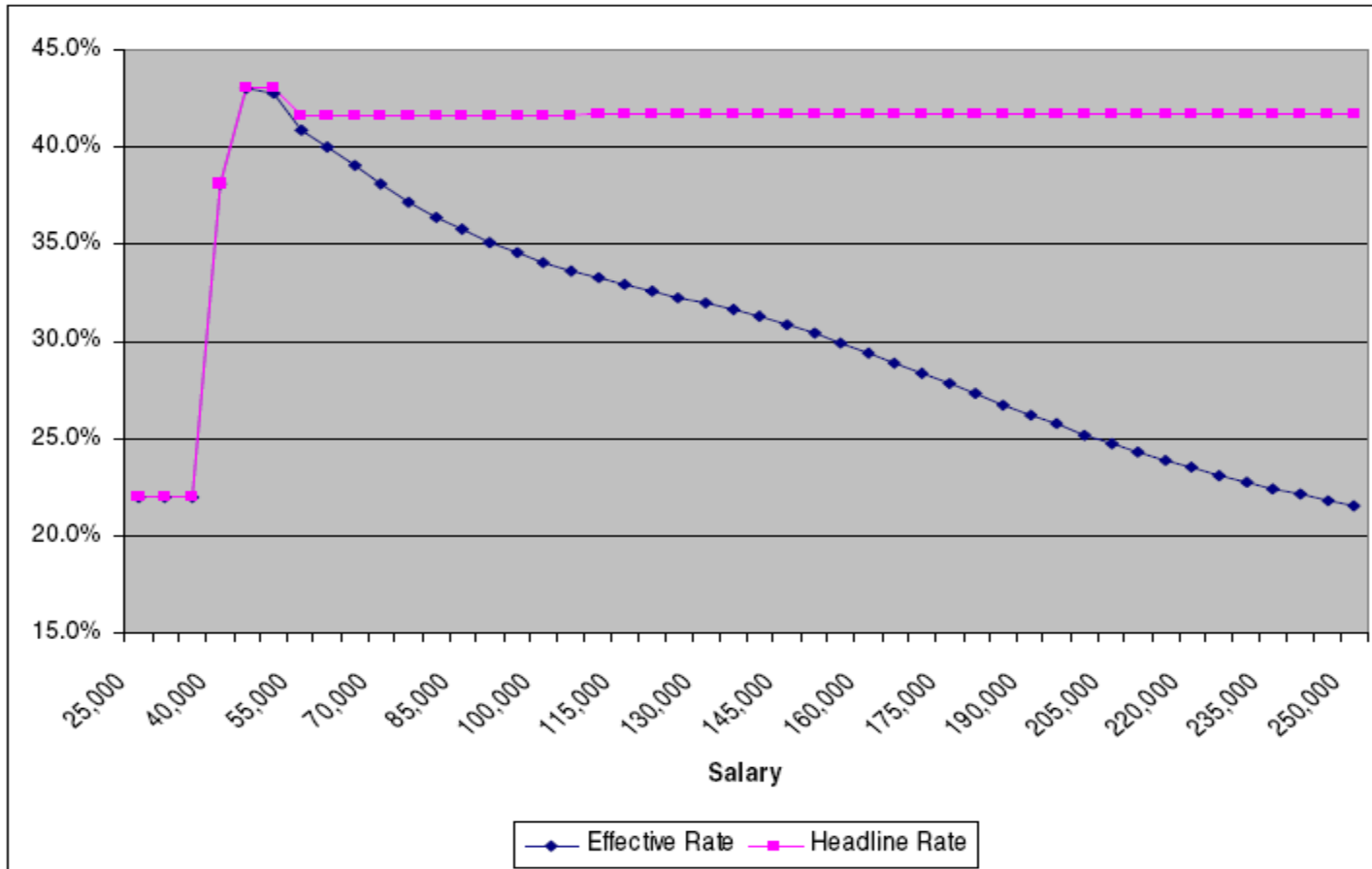


The equity argument

It is simply quite wrong to treat the relief in a year minus the tax revenue from pensions in that year as the “cost” and implicitly the net benefit received.

- The pension decision is a long term one involving streams of spending and revenues over the individual’s expected life.
- It has implications, positive and negative, for Exchequer revenues over a significant time period.
- NPV estimates required to evaluate costs, benefits.

Pre 2007 ERR No Cap



Source: M. Culligan, Life Strategies, Milliman

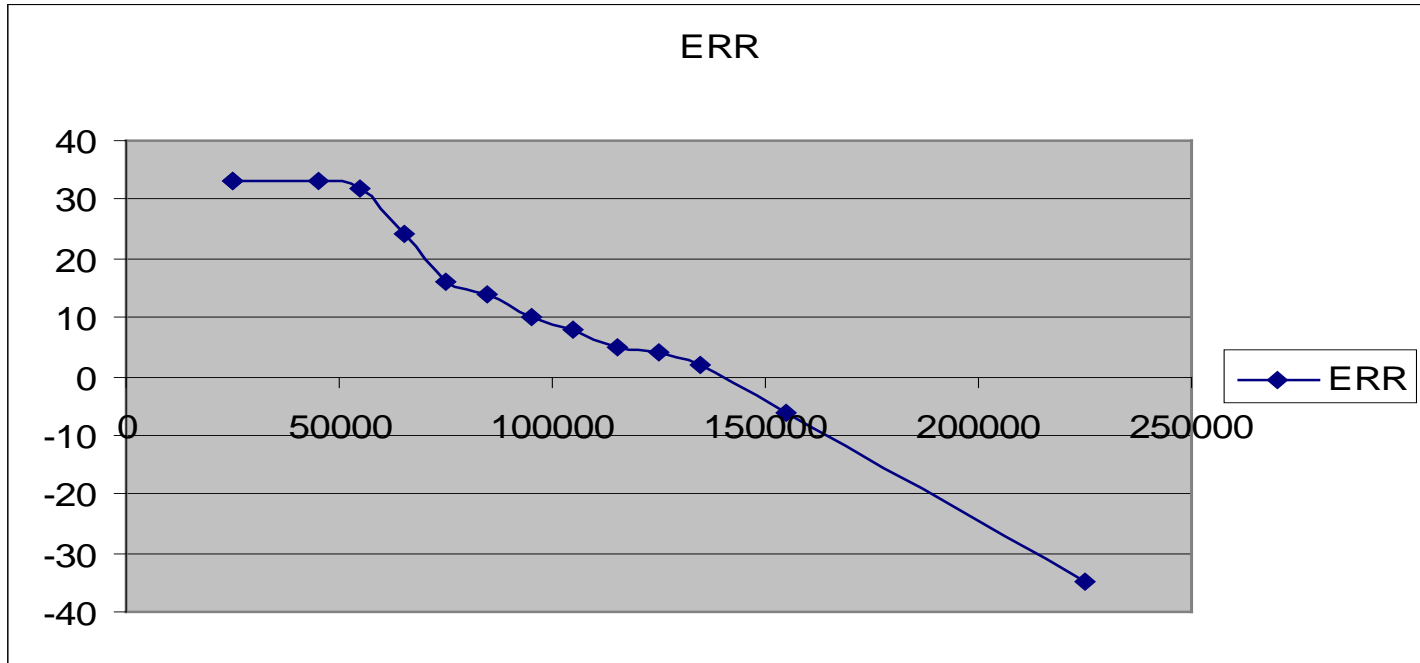


ERR vs Headline Rate

- In effect the headline relief went to zero at high income levels ...but for lump sum, because PV of high retirement income based tax offsets PV of contributions pre retirement
- Note that the max effective relief is at relatively low incomes where t for relief $\gg t$ in retirement.
- Lower middle income recipients main beneficiaries of tax relief.
- True relief (“cost”) is probably 50% or less than cash flow calculation. Also ignores alternatives.



ERR 33% Relief with LS Cap



Individual age 40: ERR at different income levels

Source: M. Culligan, Milliman



Impact of 33% relief

- Uptake was insufficient under full relief, 25% cap; the proposed change will reduce contributions rather than increase them.
- Even on conventional equity measurement basis it marks a major reduction in the real income of middle income households, and an effective tax penalty on pension saving for households on higher incomes.



Conventional equity measure unreliable?

- Conventional measure examines impact on current income of households.
- Life cycle effects ignored.
- Easy to construct an income profile with absolute equality of lifetime income across a population but significant differences in current income.
- Age adjustment not applied in conventional studies of pension contributions.



Could be better used?

- Use it to increase contr/noncontr pensions?
- Increase in state pension funding gap over next 40 years.
- Funding “cost” of current supplementary pension will taper off as demographics increase tax take from retirement incomes.
- Current “net cost” is temporary.



Conclusion

- Government proposal reflects Exchequer cash flow preoccupation.
- Likely to be presented as a move towards a Uniform Pension Structure...which it is not, while the implications of UPS not clear.
- Will penalise and reduce pension saving.
- Hard to reconcile with serious analysis of pensions equity and funding problem.