Irish CONGRESS of Trade Unions

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BRIEFING PAPER

Irish Pensions: Problems & Solutions

"The Irish pension system now has a number of serious problems. Firstly, many workers have no second pillar coverage and are facing an old age relying solely on social welfare pensions. Secondly, there are pressures on Defined Benefit schemes which have the potential to cause some schemes to fail, or to be abandoned by employers. Finally, there are problems associated with the low level of contributions and the high level of risk associated with Defined Contribution schemes.

This paper examines these problems and suggests some reforms and solutions. It will also refer to the regressive nature of our pension tax law and the tax avoidance and social inequity which invariably results."

Foreword

The Lisbon Agenda will shape the European Union of the future. If successful, it will recast the EU as the world's "most dynamic knowledge-based economy…with more and better jobs and greater social cohesion."

Five years ago, all EU member states signed up to this ambitious agenda. All are now charged with making this plan a reality.

The Lisbon Agenda rests carefully on three equal and complementary pillars: economic, social and environmental. In other words, any plans designed to make the agenda a reality must accord equal value to all three priorities: thus, social cohesion and protection cannot be sacrificed in order to pursue economic growth.

Indeed, it can be argued that the Lisbon Agenda means an end to the concept of growth for growth's sake and will attempt to ensure the market is harnessed to serve the social needs of all EU citizens.

It is crucial that the trade union movement has a strong input into this process – both at a European and national level, that the needs and aspirations of working people are factored into this grand plan for Europe.

As part of our contribution to the debate, Congress will publish a series of briefing papers – designed to stimulate debate and discussion and feed into the public discourse around the Lisbon Agenda.

This current briefing examines the oft-neglected issue of Pensions, a subject which requires urgent and comprehensive public debate, not least in Ireland. Other issues to be examined in the future include:

- Life-Long Learning
- Attracting More People into the Labour Market
- Avoiding a Two-Tier Society

I hope you will find this series stimulating and thought-provoking in equal measure.

David Begg,
General Secretary, Irish Congress of Trade Unions

May 2005

Introduction

Most developed countries try to ensure that retired citizens are provided with an adequate income. However, individual countries pursue different policies and construct different pension models to achieve this end. In most countries the largest components of the provision of retirement benefits are the social security pension arrangements. These programmes are generally pay-as-you-go (PAYG) schemes providing flat-rate weekly, bi-weekly or monthly benefits.

Ireland, the United Kingdom and the Netherlands have similar systems insofar as they use a mixture of PAYG publicly funded provision (usually referred to as First Pillar), supplemented by occupational or privately funded schemes (Second Pillar) and private personal saving. This mix of public and private provision – as distinct from other countries' heavy reliance on one or the other – is increasingly being seen as 'best practice' by bodies such as the European Commission, the OECD and the World Bank.

The European Commission is currently seeking, through the Institutions for Occupational Retirement Provision (IORP) Directive, to improve pension protection and mobility within the EU. A secondary objective of the IORP Directive is to establish a European regulatory framework based on the Irish/UK model to encourage member-states to move from heavy reliance on public PAYG provision to a greater role for privately funded schemes and personal saving.

The Commission considers that "funding will reduce future pension costs through high real returns on investments and, by improving the flow of funds for investment, increase economic growth".[1] Prevailing international orthodoxy also holds that pensions based solely on payroll charges such as PRSI, if pitched at a high level, can act as a barrier to job creation.

Situation in the European Union

Such is the diversity of pension systems, particularly since EU enlargement, that there is no standard EU pension model. However the traditional Western European model which still pertains in Germany, France and Italy is a PAYG system, partially financed by payroll tax. In these countries, there is a debate raging between those who wish to defend public provision at its existing level, those who wish to privatise pension provision and those who wish to alter the existing mix. The privateers claim that demographic trends towards a ratio of fewer workers to more pensioners makes reform necessary and that wholesale privatisation is the answer. The defenders of public provision claim that inter-generational solidarity, whereby each generation agrees to provide for its pensioners on the basis that the next generation will look after them, is still viable. They argue that if the system has survived and provided good pensions since introduced by Otto Von Bismarck in 1889, then it should be viable for a few years yet.

In Ireland, this debate has been more practical than ideological; accepting the need for some reform but not for wholesale privatisation. The debate has been informed by careful costings of the various options and analysis of other countries' experience.

The first actuarial review of the social insurance pension system[2] showed that the cost of this system, as a percentage of Ireland's GNP, was likely to double (from nearly 4% to nearly 8%, in round figures) by 2025; and that this would necessitate very substantial increases in future PRSI rates if these were to continue as the only source of finance for social insurance pensions.

It was to obviate the need for such substantial increases in PRSI – and the risk that future generations might **not** agree to pay them and might instead decide to reduce public pensions, or perhaps start means-testing them - that the Pensions' Board in 1998[3] recommended the

[1] Commission, 1999 p 8.

[2] Sept.1997 - see Bibliography.

[3] NPPI Report - see Bibliography.

establishment of a National Pensions Reserve Fund (NPRF) which would build up sufficient assets to be able to 'smooth out' the predicted bulge in social insurance pension costs when the time comes.

The United Kingdom

The UK system has a publicly funded First Pillar and a Second Pillar which relies on funded schemes based on savings invested in the market. First Pillar provision is relatively low, providing income replacement at approximately 15% of average earnings (compared with about 30% in Ireland).

Pension provision in the UK has had an unfortunate history, particularly since the Thatcher era.

The Maxwell disaster and the failure of Equitable Life contributed to a general unease about the UK system; and then, occupational pensions in the UK came under the same pressures as schemes in Ireland and elsewhere - resulting from the prolonged slump in equity values worldwide, low bond yields, high annuity prices and new accountancy standards.

Many leading UK companies have responded to these pressures by closing Defined Benefit (DB) schemes to new entrants. The government recently responded by proposing a pension protection fund but, at the time of writing, the crucial details as to how it is to be underwritten remain unclear. The 2004 Turner Report[4] provided some useful analysis of the UK system and identified trends and challenges but rather disappointingly, on its own admission, did "not make specific policy recommendations."

There are many links - in terms of culture, structure, practices, companies and indeed practitioners - between private pension provision in the UK and Ireland. Many people in Ireland believe that any UK trends - good or bad - are likely to be replicated here eventually. Anyone interested in the issue must keep a close eye on UK developments.

Successes of the Irish System

While it has not been possible to avoid the impact of global forces and influences, such as stock market slumps and the decisions of accountancy bodies worldwide, Ireland has enjoyed some successes in the pensions area, which should be recognised. These can be summarised as follows:

- Our First Pillar social welfare pension is at present equivalent to 30% of average industrial earnings. Since the National Pensions Policy Initiative [NPPI] Report was agreed in 1998 there has been a broad consensus that this should be raised to 34 % and then maintained at that level. The timeframe for achieving the 34% target was 7-10 years, which means there are only three years left, at most, to reach this target. Even then, the Contributory Old Age Pension (COAP) is likely to be below the general level of public pension provision in Western Europe generally – although it must be remembered that most of those countries rely mainly on the First Pillar and have little Second Pillar provision. Irish Social Welfare provision is better than the UK, where Second Pillar provision is similar but where public provision is only 15% of average earnings.
- The Irish Public Sector has pension provision which will ensure that with the possible exception of a relatively small number of poorly-paid staff, most will have an economically comfortable retirement.
- Many workers employed in large private sector companies and commercial state enterprise have, through their trade unions, negotiated Defined Benefit pension arrangements with their employer which are likely to provide a relatively decent income in retirement. These funded schemes will not all produce benefits on a par with the pay-as-you-go public sector schemes. Most have been facing increasing costs and a number of them have been experiencing problems in recent times which will be examined in detail later.

Higher paid employed and self employed persons have taken advantage of generous tax incentives

[4] *Pensions: Challenges & Choices* - See Bibliography.

to provide themselves with a tax friendly stream of income in retirement. This has been a success in terms of boosting pension savings but raises serious issues regarding social equity.

Emerging Problems

The Irish pension system now has a number of serious problems. These are in three main areas. Firstly, many workers have no second pillar coverage and are facing an old age relying solely on social welfare pensions. Secondly, there are pressures on Defined Benefit schemes which have the potential to cause some schemes to fail, or to be abandoned by employers. Finally, there are problems associated with the low level of contributions and the high level of risk associated with Defined Contribution (DC) schemes.

This paper examines these problems and suggests some reforms and solutions. The paper will also refer to the regressive nature of our pension tax law and the tax avoidance and social inequity which invariably results.

Lack of coverage

The 1998 Report of the National Pensions Policy Initiative Report (titled 'Securing Retirement Incomes' but better known as NPPI), started by recognising that due to the low levels of Second Pillar coverage "a significant segment of the workforce and their dependants are at risk of experiencing a sharp drop in living standards when they become pensioners." Since then, as a result of better data collection by the CSO (one of NPPI's many recommendations), there is more information on who exactly comprises this 'significant segment' at risk.

Pension coverage is highest amongst top income earners, both employed and self-employed. Coverage is relatively high for public administration workers, with 87.8% of such workers in membership of a scheme. Amongst private sector workers coverage is low, with construction, retail and catering showing rates of 34%, 26% and 12.5% respectively.

Coverage also varies with age and gender. Younger workers tend to have less coverage than older workers and women have less coverage than men. Part-time workers have a low level of cover with only 15% of those working between 10 and 19 hrs per week in membership of a scheme.[5] Those who have no Second Pillar coverage are in most cases facing a bleak retirement. Public pension provision may keep such people from penury but will do no more. Even if the NPPI target of 34% of Average Industrial Earnings is achieved by 2008, this will not be adequate.

Static Coverage

Membership of occupational pension schemes – mainly DB - climbed steadily from the end of World War II until 1985. However, ERSI reports in both 1985 and 1995 and the CSO report of 2002 all indicated that there had been no substantial improvement in DB coverage after 1985. Although membership continued to grow, virtually all of that increase was in DC schemes, and overall pension scheme membership - as a percentage of the labour force - did not rise. It remained static at around half the labour force: 46% in 1995, 50.2% in 2002 and 52.4% in 2004.

Two clear factors led to the halt in the spread of DB schemes and it is reasonable to suggest other, less obvious factors. Firstly, Foreign Direct Investment from the United States saw the establishment of large employments which favoured DC provision. Secondly, insurance companies began to market DC to employers and they proved attractive as they were usually much cheaper. The less obvious reasons for the halt in growth of DB were that good pension provision has always been closely related to unionisation and company size. By 1985 most of the big unionised companies were providing DB cover - only those employers who could not afford a DB scheme remained outside the loop.

The perception that pension schemes are now very costly is likely to stiffen employer resistance to the introduction of new schemes. Even if unions succeed in overcoming such resistance, they are likely to be offered DC schemes with low levels of employer contributions. Successive Social Partnership agreements since 1987 have allowed

[5] CSO Sept. 2004.

unions to pursue claims for the introduction or improvement of pension schemes, in limited circumstances, and although this has facilitated some improvement in coverage, the huge growth in the size of the labour force has meant that as a proportion of the labour force, coverage has remained static. Equally important, the quality of coverage has declined due to the increasing preponderance of cheaper, i.e. inferior, DC schemes.

The PRSA Option

One of the main recommendations of the National Pension Policy Initiative (NPPI) was the introduction of Personal Retirement Savings Accounts (PRSAs), which were designed to increase pension coverage among the 'significant segment' of the workforce with no occupational pension and no realistic prospect of securing one. Employers were obliged, as and from September 2003, to make a PRSA available for any worker who did not have a Second Pillar pension. If an employee decides to take out a PRSA, the employer must now deduct the contribution from salary and return it promptly to the PRSA provider. If the employers so choose, they can make a contribution, but there is no obligation on them to do so.

It was hoped that the availability of PRSAs would help increase coverage to 70% of the working population aged 30-65, by 2006. The target group is those without Second Pillar cover, e.g. the lower paid, women and atypical workers.

Unions contend that employers have a moral responsibility, along with workers and the State, to make contributions to funds which will yield an adequate retirement pension; and many employers have accepted this responsibility. However, employer organisations have consistently resisted the demand for mandatory pension contributions. It had been hoped that employers would be encouraged through collective bargaining to make a voluntary contribution to PRSAs. International experience suggested that the target audience would not respond to a PRSA-type product unless the employer was seen to contribute. To date, very few employers have made contributions and, predictably, few workers have availed of the PRSA option.

Thus, the effect of PRSAs on pension coverage has been negligible, since their introduction in September 2003. The September 2004 CSO Quarterly National Household Survey showed a slight increase in overall coverage, up to 52.4% of the workforce. But as non-standard PRSAs are often used for 'tax planning' by top earners it is likely that even this modest take up has as much to do with the rich getting richer, than increased coverage amongst the target group.

It now seems highly unlikely that 70% coverage target - by September 2006 - will be achieved. This is unsurprising given the government's reluctance to use the only effective instrument at its disposal – the tax incentive – to assist the take-up of pensions or PRSAs by people on low incomes. Prior to Budget 2005, unions warned that this was the government's 'last chance' to adjust the tax incentive in favour of the lower-paid but, unfortunately, those warnings went unheeded.

Can PRSAs Work?

The Pensions' Board has also been looking at ways of breathing life into the PRSAs, by way of maturing SSIAs, or other tax incentives. Unions had been the earliest critics of the SSIAs, arguing that the then Minister for Finance was undermining attempts to encourage long-term savings for retirement, like pensions or PRSAs, by introducing an apparently more attractive short-term savings plan for what appeared to be mainly electoral reasons. We argued that this would inevitably divert available monies away from the PRSAs due to be introduced the following year.

Tacit acceptance of this was implied by the Minister's assurance to Congress, in the context of Budget 2002, that measures would be put in place to encourage the conversion of SSIAs into pensions/PRSAs 'when the time comes'. In the context of subsequent Budget submissions and negotiations, and also during the Sustaining Progress talks in early 2003, this approach was advocated by Congress and found widespread favour, but not with the Department of Finance.

Calls for improved tax treatment of lower-paid workers for pensions and PRSA contributions have been resisted by Finance on the grounds that current tax treatment of pensions is 'already generous' and 'a considerable burden on the State'. However as shown elsewhere in this paper, the target groups for improved pensions and PRSAs are not the ones benefiting from this 'generosity' and adjustments are required if they are to do so.

The case for extra tax incentives directed at lower-paid people is a strong one. However a PRSA with strong tax support and only a worker contribution lets the employer off the hook in relation to making a contribution. Not only is it unfair to the workers concerned, but it may send a negative message to those employers who have hitherto been prepared to shoulder a financial burden by making their contribution to employee pensions.

At present, there is no obligation on employers to contribute to PRSAs, and there also is a windfall gain for them when a worker avails of a PRSA. This is because there is no obligation to pay employers' PRSI on these monies (i.e. employers' PRSI is calculated on the worker's salary less his or her pension/PRSA contribution). There is a strong case for insisting this windfall gain should be ploughed back into the PRSA.

Mandatory Pension Provision

Unions have argued that the only way to ensure widespread coverage of Second Pillar pensions is to compel the employer to establish such schemes and make a contribution to their employees' fund. The NPPI envisaged that if PRSAs fail to deliver the increased coverage required, compulsion will need to be considered again. This is one of the major issues to be addressed in the context of the National Pensions' Review, to be carried out three years after the introduction of PRSAs, i.e. by September 2006. That Review has now been brought forward, by Minister Seamus Brennan; and the Pensions' Board has been asked to complete it within the coming months.

Compulsion is not without difficulties. Many employers are opposed to compulsion on the grounds that it would increase their labour costs and affect competitiveness and employment - much as they would react to any proposed increase in PRSI. On the other hand, those employers who are already paying substantial sums into good schemes might welcome the fact that their competitors were obliged to do likewise, as this would reduce the element of 'unfair competition' inherent in the present voluntary system. However, mandatory employer contributions could lead some employers into reducing their contributions to the level at which the mandatory contributions are set, posing major problems for many existing schemes.

There could also be worker resistance to compulsion. If government compels employers to pay into a pension fund, it is very likely to also compel employees to make a minimum contribution. As workers already have the voluntary option to do so – an option many have failed to exercise - compulsion may be seen as a tax. It may even be seen as an insidious tax, one that will not go to the state, but rather to a private insurance company which might speculate with these monies while the worker takes the investment risk. Workers may also fear that the insurance company and/or investment manager may overcharge for the administration of the fund.

There is concern about high overheads and administrative charges for DC schemes, AVCs and PRSAs at present. The fact that allowable charges for standard PRSAs have been capped by law, to allay such fears, has not diminished the widespread perception of overcharging – even though PRSA providers would argue that this capping has made PRSAs virtually unsaleable!

Workers may also take the view that they are already in one mandatory scheme, in that they are forced to pay PRSI, and that this new compulsion would be yet another burden, this time designed to force them to shift consumption from their present needs to their old age. Those that wanted to supplement the PRSI provision for their old age had a good tax incentive to encourage this on a voluntary basis – provided they were on higher marginal rates of tax – and might see compulsion as inevitably driving that tax incentive downwards. This would be perceived very negatively by people planning long-term savings for retirement on a tax basis that had seemed secure, but might now become shaky. It could even be viewed as an act of bad faith on the part of the government.

Over the last five years, most members of pension schemes have seen negative investment returns to their funds and their confidence in the system has been shaken. The cost of annuities has rocketed; and the value of many pensions, especially self-employed pensions, has fallen dismally. It would be a brave government that would compel workers to invest in a pension in such circumstances unless very significant levels of security can be assured.

Mandatory Provision Abroad

It has been argued that mandatory provision, while undoubtedly improving coverage can have damaging effects on pension quality. This was the experience in Australia and Hong Kong. A study conducted in those jurisdictions on behalf of a major Irish pensions provider found that: (a) while a high level of coverage, in terms of numbers covered, is only achievable through compulsion; (b) in such an environment, "the quality of the coverage is low and previously good quality cover tends to reduce, over time, to the compulsory level".[6]

A more recent study of the Australian system suggests that the introduction of compulsion led to the demise of DB even in the Australian public service.

The Success of Defined Benefit Schemes

Defined Benefit schemes have long been the favoured option for trade unions, and for good reason. From the end of World War II, wherever Irish unions had sufficient industrial strength they negotiated DB schemes for members. Until recently, most DB schemes were in surplus and they continue to provide a good income stream for many thousands of pensioners.

By the end of 2003, there were 1,541 funded DB schemes in Ireland, which will provide benefits to over 230,000 employees[7] and their dependants. There are another 250,000 members of DB pay-as-you-go schemes which are not funded, or subject to the MFS: these are the public sector schemes whose benefits are guaranteed by statute. Another 240,000 workers are in DC schemes. When members of public service schemes are taken into account, the proportion of DB to DC is still about 2:1. Nevertheless, the drawbacks and problems besetting such schemes must be faced. It should be possible for most to continue in their current form and deliver a sustainable pension to members. During the recent problematic period for DB schemes, nearly 50% had difficulty meeting the Minimum Funding Standard (MFS). However 25% of schemes availed of the increased flexibility introduced on the recommendation of the Pensions' Board.[8] Therefore three-quarters of all DB schemes apparently believe that they can recover in the foreseeable future and all reasonable measures to facilitate this must be supported.

What Caused the Difficulties?

It is widely believed that the unprecedented fall in global equity markets, over a three-year period, has caused most damage to DB schemes. If that is so, the optimists tell us we have little to worry about. The markets will recover in time and even recent history suggests that equities will give a reasonable return over a prolonged period. However, equity markets are not the only factor to contend with.

Equities might never again reach the dizzy heights of the early nineties. The pessimists suggest that it is reasonable to assume that the growth in equities must bear some relationship to the growth in national income.[9] If this is so, we can expect equities to do little more for pension funds than to act as a hedge against inflation. If that is the best that can be expected, then bonds are a better option because they protect against inflation without exposing the fund to the risk associated with equities.

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6 Pension Providert, 2000.

7 This refers to funded schemes subject to the Minimum Funding Standard[MFS].

8 The option to reach the Funding Standard over ten rather than three years; and in some cases, even longer.

9 See the long death of the cult of equity [FT 7 Jan 2005] S Brittain.

Even if the optimists are right and there is a sustained recovery in equities, there are other factors negatively impacting on DB schemes which are unlikely to go away, particularly increased longevity and low interest rates.

People Living Longer

Members have added to pension costs by living healthier lifestyles and posing what the pension industry refer to as 'the longevity problem'. What is good news for us as human beings is bad news for pension funds. In 1984 the life expectancy of a 65 year-old man was 13 years. Today it is 16. This does not seem like a big difference but it means that the cost of a pension for a 65 year-old has increased by 25%. For women the increase has been from 16 years to 19 years.

Because pension scheme liabilities mainly relate to current employees rather than pensioners, allowance also has to be made for further expected improvements in mortality. Current best estimates suggest a 19 year pension payment period should be assumed for a man retiring at 65 with a spouse's pension payable for a further four years. Schemes which allow retirement at 60 have a significantly heavier burden to carry.

Pension funds usually purchase annuities to meet the cost of a pension in payment. If the annuity provider expects to pay the pension for longer the price of the annuity rises substantially. This has happened in recent years – not only because of increased longevity but also because of lower interest rates.

Low Interest Rates

In recent years, we have seen interest rates fall from 9% to 4%. This has an impact on the purchasing power of pension funds since the cost of annuities rise as interest rates fall. It is likely that interest rates are set to stay low for a considerable time Bond yields are likely over time to a more normal rate of 5% to 6% per annum.

We have seen that increased longevity also pushes up annuity costs. The Irish Association of Pensions Funds has estimated that in 1979 €10,000 could buy an annuity which would purchase €1,200 of yearly pension. By 2002 the same amount could buy less than €500 of yearly pension.[10]

Financial Reporting Standards

Annuity prices were rocketing, bonds were performing poorly and equities were delivering exceptionally poor returns. As if that wasn't enough, along came Financial Reporting Standard 17 (FRS17). This demanded that companies show their pension liabilities in the annual accounts. Pensions are by definition a long-term investment and year-on-year performance is not as important as the long-term result. The volatility which the recording of pension liabilities introduces to company balance sheets can have huge consequences for dividends and share prices – not to mention decisions about pensions. FRS17, coming as it did on top of the other problems, has caused many companies to reassess whether they are prepared to continue with their DB promise to their employees.

Defined Benefit - damaged by kindness

DB schemes were constructed to deliver decent benefits to their members. Unions have sought to improve their members' benefits and the Pensions' Board, has improved the security, accountability and quality of DB schemes. But these laudable objectives could only be achieved at a cost. Actuaries and union officials believed that Defined Benefit was best regardless of the size and profile of the sponsoring enterprise. When constructing a good scheme they tried to at least match the benefits available from the Public Service pay-as-you-go scheme. The target was usually a pension based on salary at retirement (either a maximum 50% pension plus lump sum, or the actuarial equivalent, a two-thirds pension less a cash option/lump sum), with a 50% pension for the spouse on the death of the member (a construct of a time when the woman's place was generally in the home). It was also thought desirable that some form of post-retirement escalation, whether based on the rate

[10] IAPF, 2003, p24 - see Bibliography..

of inflation, or very occasionally on final salary, should be a feature of a good DB scheme.

Unions pursued improvements in schemes. They also strove to increase wages, which inevitably increased the liabilities on schemes. Unions and employers often dealt with redundancies by early retirement, which also added to costs. The Pensions' Board decided that the benefits of early leavers should be preserved and periodically re-valued to ensure, that these benefits were not wiped out by inflation. It also placed administrative and disclosure obligations on schemes, the cost of which impacted disproportionately on smaller schemes.

The accumulating costs associated with all these improvements were largely hidden at first, because they happened in a period of market buoyancy. Schemes were carrying surpluses. Employers were taking 'contribution holidays', unions were seeking improved benefits and Revenue rules demanded that surpluses be reduced.

The Problems Multiply

The growth of DB had been halted but we continued to pile benefit on top of obligation. If we counted the cost, we did so on flawed assumptions and underestimated the cumulative impact. Then came the prolonged plunge in equity returns along with FRS 17. Some Defined Benefit schemes could not meet the minimum funding standard: around 50% of schemes had problems. The Pensions' Board sought ways to avoid adding to the pressures on schemes. Everyone hoped the markets would recover and get back to 'normal'. However the crisis has forced pension experts to ask themselves two hard questions: firstly, were the problems facing Defined Benefit a result of temporary difficulties that could be overcome, or did they arise from irreversible developments or a flawed pension model?; secondly, could funded Defined Benefits schemes provide a sustainable decent pensions at a cost employers and workers could afford, or were prepared to pay?

Drawbacks of Defined Benefit

DB schemes are seen by unions to be a trustworthy vehicle for delivering good pensions for members. The model has its drawbacks. To receive maximum benefit a worker must spend a whole career working for the same organisation and have no breaks in their employment history. Many workers still crave employment security but many also wish for, and need, the opportunity to change employer during their career. The nature of modern enterprise is such that not only companies but entire industries come into existence and go out of existence over relatively short periods of time. In a DB scheme, "the risk involved for members is spread over several decades, quite long enough for a company to go from being a favoured blue chip company to an abandoned hulk." (Blackburn, R, ICTU Pension Conference, May 2003).

Workers who change career can be big-time losers in a DB scheme. Women can be particularly disadvantaged as they tend to spend more time out of the workforce and change jobs more often. The well-intentioned decision of the Pensions' Board back in the late 1980s to insist on re-valuation of early leavers' benefits now puts a heavy burden on active members. If an industry is in decline, many workers will leave and be entitled to a re-valued deferred benefit. A reducing number of active members coupled with an employer whose business is contracting, will be asked to shoulder a growing burden. Such schemes may not be sustainable in the long term.

Some employers have responded by closing their DB schemes to new members, falsely claiming that doing so protects existing members of the scheme. But closing a scheme to new members is the worst possible response: it will, over time, drive up the costs per member and without new members to make contributions, eventually the scheme will become unsustainable.

The Way Forward

In spite of these difficulties, Defined Benefit remains the best option for the majority of those who are fortunate enough to remain in or become members of such schemes. Government, unions and employers have an obligation to protect these schemes and to avoid adding to their difficulties. Regulation should be such as to give security and accountability without adding to costs. Unions must remember that improving benefits may be counter-productive if sustainability is threatened; and employers must never again take contribution holidays. This will require a change in Revenue rules.

There is very little prospect of the coverage of DB being extended much beyond its current level. Unions must fight to retain all existing DB schemes and keep them open to new entrants. If, however, coverage is to increase, it will be on a largely DC basis. This means much more attention should be given to the security and sustainability of these schemes in the future.

Currently, about 16% of occupational pension schemes are funded on a Defined Contribution (DC) basis, while 33% of members of schemes are in DC schemes as such schemes are generally smaller than DB ones. Nearly 70% of these DC schemes have been established since 1991.

Thus, as already noted, DB coverage has not increased since the 1980s. Any significant growth in pension cover has been, and will continue to be, DC and this includes PRSAs.

DC schemes have had a bad reputation amongst trade union members, and rightly so. There are two reasons: firstly, neither employers nor employees normally made sufficient contributions to produce adequate pensions; secondly, both the investment risk and the annuity risk are borne by the DC scheme member. This was seen as unfair to the member and also unduly irresponsible on the part of the employer. However, increased awareness and vigilance can help to ameliorate these problems, if there is a willingness to increase contributions to appropriate levels.

Raising Contributions

Accordingly to the IAPF in 2003, the average total contribution rate to DC schemes was just over 10% of salary. The normal benchmark, both nationally and internationally, was that a good pension would give two-thirds of salary at retirement (including the social welfare pension). But even over a full 40-year career, contributions of 10% would not yield that level of pension.

In one sense, the solution to this problem is easy. Employers should pay at least 10% of salary and employees should pay at least 6%. This would not be enough in every circumstance, but it would be much better than the current situation. This level of contribution would have to be maintained over a working life-time in order for an adequate level of pension to result.

Unions which represent workers in DC schemes should lodge claims for increases up to the levels that are indicated to be appropriate; and workers should be prepared to play their part by committing to a reasonable proportion of the total contribution required. Regular actuarial valuations should be carried out on all DC schemes to show workers and employers whether they are contributing enough.

The investment risk inherent in DC schemes is clear. The fund is invested and if it produces a good return, well and good. If, however, the return is poor or there are losses, it is the individual that has to bear the cost.

The annuity risk is more complex. When a DC member retires, an annuity must be purchased to produce the pension. The annuity is purchased in the market place so, in theory, the price can go up or down. We have seen that the price of annuities has been steadily increasing for more than two decades. The only certainties a scheme member can have is that the annuity will be expensive; that the member will carry this risk; and that a very expensive annuity will yield a paltry pension.

Can anything be done to lessen the risk in DC schemes?

There is little scope for avoiding investment risk, but if smaller DC schemes were to amalgamate, the risk could be spread more widely. Such amalgamations could achieve economies of scale which might mean that less of the members' pot is absorbed by administration costs and charges. There are also other possibilities:

- **A 'halfway house'**

  If an employer and a union agree that, say, 16% of pensionable salary will be invested into a Hybrid DB/DC fund, the risk could be shared. Actuarial projections could determine what the first 8% should yield in terms of Defined Benefits. The employer would guarantee this amount and then meet the balance of cost. The other 8% could be treated on a normal DC basis with the employee taking the risk. Such a solution would only be acceptable to improve DC scheme. It would never be acceptable as a way of diluting a DB scheme. *What is required is an agreement on a new Hybrid DC vehicle, with higher contribution rates, which would share the risk between the employer the employee and the State;*

- **A State Annuity**

  The Pensions' Board is currently examining the idea of a State annuity scheme to deal with DB schemes facing closure. This could involve the National Treasury Management Agency (NTMA), or perhaps the National Pensions Reserve Fund (NPRF), taking over the payment of pensions to people whose schemes had been wound up, provided that sufficient assets had been transferred to enable this to happen;

  This idea should also be examined in detail to see if an annuity provided via the State for DC members as well, would be cheaper than those currently provided by insurance companies. The State would not need to make a profit on such annuities;

  If a State annuity proved viable, it could be of great benefit to both DB and DC schemes. It could make DB cheaper and reduce the annuity risk in DC.

- **Supplement the State pension**

  A further option would be that when a DC pension matures, the pensioner could be given the option of purchasing extra Social Welfare pension with their accumulated fund. This option would help neutralise post-retirement risk.

For example, €800 accumulated pension fund = €1 per week of Social Welfare pension

Revenue Rules & Tax Avoidance

Government encourages the extension of Second Pillar pension coverage by providing incentives to employers and employees who are prepared to invest in a pension fund. However it is argued by some people, notably Gerry Hughes of the ESRI, that the "tax treatment of private pensions is inequitable as most of the benefits accrue to taxpayers at the top and very little to those at the bottom of income distribution." The cost of this tax relief has escalated over the years. In 1980/81 the total cost was £40m, or 0.4% of GDP. By 1999/00 the cost had risen to £844m, or 1.4% of GDP.

The top 10% of earners receive 40% of the benefit of this relief; and the other 60% goes to middle income earners, including large numbers of PAYE workers in occupational pension schemes. The incentive to defer tax on a proportion of current income has been a persuasive factor in providing income for retirement.

Thus, under the present tax regime, it is possible that a wealthy individual at age 50 could put up to 30% of their yearly income - to a limit of €254,000 pa - into a personal pension until they retire. It has been calculated that a person who is in a position to invest the maximum at every stage could have a lump sum on retirement of either €2m, or €3.5m.[11] They can transfer all but €50,000 into an Approved Retirement Fund. The balance is taxable as it is drawn down but, if the lump sum is very large and the pension element substantially reduced, such individuals may have avoided a massive amount of tax at a huge cost to

[11] This calculation can be done on two assumptions i.e. that the limit stays the same, in the case of the former figure; or that it rises in line with earnings, in the case of the latter

the Exchequer. To make a bad situation worse, new rules have been developed to allow such individuals to borrow into their so-called pension fund in order to buy property. The IORP Directive will outlaw this type of borrowing for occupational schemes but it may not apply to the individual schemes. (In the Social Welfare and Pensions Act, 2005, Minister Brennan, when implementing this part of the IORP Directive, left this issue open for the time being by reserving enabling powers to make exemptions.)

If Revenue rules and various Finance Acts, which are supposed to promote funded pension, provision are used for tax avoidance and profiteering, then not only will the system be brought into disrepute but there will continue to be a transfer of State funds to very wealthy individuals. Borrowing for pension funds should be banned for all schemes.

Tax allowances should only apply to a level where the pension will not exceed four times the average industrial wage. The resultant tax savings could also be redirected in other positive directions, e.g. to help achieve the figure of 34% of average industrial earnings for the First Pillar pension, or to underwrite a Pension Protection Fund based on the UK model.

There is no Magic Bullet

If all funded schemes, both DB and DC, were rolled up and became part of social insurance, members of schemes would be paying the same amount as now but expressed as a PRSI payment. Workers who were currently not members of an occupational scheme could be compelled, along with their employers, to make larger PRSI payments and receive a higher level of First Pillar pension.

The critics of this proposal would say that higher PRSI contributions would be disastrous for employers and the loss of investment capital would be ruinous for the economy. The Financial Services industry would react negatively. We have seen earlier, the Western European model of high public provision is under attack and any attempt to move in that direction would be politically unacceptable both nationally and internationally.

We must therefore posit solutions which have some possibility of achieving consensus.

Conclusions & Proposals on Coverage

- Many workers have no Second Pillar coverage and are facing an old age relying on Social Welfare; therefore it is imperative that social welfare pensions are increased to the agreed NPPI target levels of at least 34% of Average Industrial Earnings;
- The evidence suggests that collective bargaining is unlikely to significantly increase pension coverage in the foreseeable future;
- The effect of PRSAs on pension coverage has been negligible to date and will remain so unless employers contribute and/or the State increases their support and incentives;
- The case for extra tax incentives directed at lower paid people is a strong one and the proposals put forward for tax credits and other measures to incentivise the conversion of SSIAs to pensions/PRSAs;
- The employers' PRSI windfall gain should be ploughed back into the PRSA;
- Compulsion would lead to much higher coverage but would not necessarily improve the quality or adequacy of coverage and might even pose a threat to existing DB schemes; therefore it should not be seen as a simple solution without any downsides for those for whom we have already achieved reasonable coverage. There could be worker as well as employer resistance to compulsion.

Conclusions & Proposals on Defined Benefit schemes

- Defined Benefit (DB) schemes have been a success and everything possible should be done to sustain existing schemes;
- Revenue rules discouraging surpluses should be revoked. Schemes should be allowed to accumulate surpluses so as to offset losses in bad times;
- Most DB schemes are safe and will be able to meet the required MFS now that the latter has been adjusted; however, there are some which have the potential to fail or to be abandoned by employers and this should be prevented by law in cases where the company is continuing as a going concern. In cases of insolvency, better protections for workers than currently exist must be introduced as a matter of urgency. A small number of failures could stimulate a chain reaction and undermine confidence;
- Employers must be dissuaded from closing DB schemes to new entrants as this undermines their long-term viability; however, it must be recognised that in the absence of overall compulsion it might be difficult to compel only certain schemes to continue in existence.

Conclusions & Proposals on Defined Contribution schemes

- In future, most new schemes are likely to be Defined Contribution (DC);
- Hybrid DC schemes should be developed which can allow workers and employer to share the investment risk but only to improve DC never to dilute DB
- The low level of contributions to DC schemes must be addressed e.g. by employers agreeing to a 10% minimum contribution and employees agreeing to pay at least 6% of salary or whatever contribution levels are deemed appropriate. Regular actuarial reviews of DC schemes should be carried out to determine this;
- There is no way of avoiding the investment risks associated with DC but at least some of the risks could be shared and a State provided annuity could help to reduce costs and provide greater stability;
- Pensioners with accumulated DC funds should have the option of purchasing supplementary Social Welfare pension.
- Unions should make claims on Employers where PRSAs have ben established to contribute 10% to the PRSA. The worker should agree to contribute 6%.

Notes

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