Table of contents

Glossary and abbreviations 3
1. Executive summary 9
2. Background 21
3. Key objectives and policy context 23
4. Approach and background 32
5. Overview of mandatory systems 36
6. First pillar model 43
7. Supplementary model 53
8. Soft mandatory models 88
9. Hybrid model 97
10. Conclusion and recommendation 108
Appendices 114

The Pensions Board

Board Members
Tiarnan O Mahoney (Chairperson)
William Beausang
Kevin Brabazon
Rosalind Briggs
Rosheen Callender
Julian Caplin
Marie Daly
John Dillane
Mary O'Donnell
Emer O'Flanagan
Michael O'Halloran
Gerry Ryan
Dervla Tomlin
Anne Vaughan
Mary Wade
Fergus Whelan
Tom Wright

Oversight Committee
Tiarnan O Mahoney (Chairperson)
William Beausang (Dept. of Finance)
Rosheen Callender, (ICTU)
Marie Daly (IBEC*)
Brendan Kennedy (Board Executive)
Anne Maher (Board Executive)
Jerry Moriarty (Board Executive)
Paul Morrin (Dept. of Social and Family Affairs)
Anne Vaughan (Dept. of Social and Family Affairs)
Fergus Whelan (ICTU)
Yvonne White (Board Executive)

(*IBEC withdrew its representative in May 2006)

Board Executive
Anne Maher (Chief Executive)
Philip Dalton
Tom Dunphy
Mary Hutch
Brendan Kennedy
Sylvia McNeece
Jerry Moriarty
Yvonne White

Consultancy Support Work
Economic and Social Research Institute
Fitzpatrick Associates
Life Strategies

Glossary and abbreviations

Annuity	*A series of regular payments payable throughout the lifetime of the payee. It is normally secured by the payment of a lump sum to an insurance company*
Adequacy	*A measure of how much pension will be provided at retirement compared to income before retirement. This includes both first and second pillar pensions.*
Approved Retirement Fund	*A fund in which certain retirement funds can be invested rather than purchasing annuities*
Consumer Price Index	*The Consumer Price Index measures the change in the average level of prices paid for consumer goods and services by all private households and foreign visitors to Ireland and is the official measure of inflation in Ireland.*
Contributory State Pension	*A social insurance payment (part of the First Pillar) made to people age 66 or over who satisfy certain conditions. Entitlement is based on PRSI contributions paid and the benefit is not means tested.*
Coverage	*A measure of the proportion of the workforce that have supplementary pensions.*
Defined Benefit	*An occupational pension scheme where the benefit payable is determined by reference to earnings and length of service*
Defined Contribution	*An occupational pension scheme where the benefit payable is solely dependent on the value of the contributions that have been paid to the scheme and the investment return earned on those*
First Pillar	*Retirement pensions paid by the State under its social protection programme. In Ireland these are the Old Age (Contributory) Pension, Old Age (Non-Contributory) Pension and State Retirement Pension.*

Funding Standard	*This is a standard that requires defined benefit schemes to have enough assets to secure, in a wind-up position, the pension rights that members have built up. Defined benefit schemes must certify regularly whether or not they satisfy the funding standard.*
Gross Average Industrial Earnings	*Average earnings of industrial workers in manufacturing in Ireland, as measured by the Central Statistics Office.*
Hybrid model	*This term has been used to describe a mandatory system that comprises an increase in the State pension and a mandatory supplementary pension scheme.*
Gross National Product	*A measure of the total annual Irish economic output. At the beginning of 2006, the Central Statistics Office estimated this to be €136 billion.*
KiwiSaver	*KiwiSaver is a voluntary, work-based savings scheme. Its aim is to encourage well informed savings habits and asset accumulation to improve New Zealanders' financial wellbeing, particularly for retirement.*
National Pensions Policy Initiative	*An initiative jointly sponsored by the Department of Social, Community and Family Affairs and the Pensions Board. It was launched in 1996 to facilitate national debate on how to achieve a fully developed national pension system and to formulate a strategy and make recommendations for actions needed to achieve the system.*
National Pensions Reserve Fund	*A fund established by the State designed to pre-fund some of the projected increases in the cost of State and Public Service pensions.*
National Pensions Review	*A review conducted by the Pensions Board in 2005, at the request of the Minister for Social and Family Affairs, on pension coverage in Ireland and associated issues, which culminated in a report presented to the Minister in November 2005.*

Non-Contributory State Pension	*If an individual does not qualify for an Old Age Contributory Pension (OACP) if they qualify for OACP at a reduced rate, they may opt to be means-tested for an Old Age (Non-Contributory) Pension. The current maximum personal rate is €166.00 per week*
NPPI Report	*The report published as a result of the National Pensions Policy Initiative in 1998, titled "Securing Retirement Income"*
NPPI targets	*The National Pensions Policy Initiative devised specific targets relating to pensions coverage and adequacy.*
Occupational Pension Scheme	*A pension scheme, established by and at least partly funded by an employer for the benefit of employees*
Pay As You Go	*The approach taken where benefits are not pre-funded but are provided out of current contributions. State pensions and Public Service benefits are provided on this basis.*
Pensions Acts	*The Pensions Act, 1990 (as amended). This is the main legislation governing occupational pension schemes and Personal Retirement Savings Accounts in Ireland*
Personal Retirement Savings Account	*An individual investment account used for retirement provision.*
Retirement Annuity Contract	*A contract used for pension provision by self-employed and people in non-pensionable employment.*
Second Pillar	*Pensions received in addition to First Pillar pensions. In Ireland these may be occupational pension schemes, PRSAs or personal pensions. Also called supplementary provision.*

Social Partnership	*Social partnership in Ireland is an approach to government where interest groups outside of elected representatives play an active role in decision taking and policy making on a range of social and economic issues and to reach a consensus on policy.*
Soft Mandatory	*Pension system where eligible workers are obliged to join but have the right to opt out and cease contributing if they wish.*
Standard PRSA	*A Personal Retirement Savings Account that must comply with certain investment requirements and capped charges. Employers must grant their employees access to such a product where no, or a restricted, occupational pension scheme exists.*
State Retirement Benefits	*This is a social insurance payment made to people reaching age 65 who satisfy certain conditions. The amount is based on PRSI contributions paid and the benefit is not means tested. A person must be retired from insurable employment to receive this pension.*
Supplementary provision	*Pensions received in addition to First Pillar pensions. In Ireland these may be occupational pension schemes, PRSAs or personal pensions.*

Abbreviations

ARF – Approved Retirement Fund

Board – The Pensions Board

BVG – Current Swiss defined contribution pension plan

CPF – Central Provident Fund (Singapore)

CSO – The Central Statistics Office

DB – Defined Benefit

DC – Defined Contribution

ESRI – Economic Social & Research Institute

EU-SILC – EU Survey on Income and Living Conditions

GAIE – Gross Average Industrial Earnings

GNP – Gross National Product

IMF – International Monetary Fund

NESC – National Economic and Social Council

NPPI – National Pensions Policy Initiative

NPR – National Pensions Review

NPRF – National Pensions Reserve Fund

NPSS – National Pensions Savings Scheme (UK)

NTMA – National Treasury Management Agency

OECD – Organisation for Economic Cooperation and Development

PAYG – Pay As You Go

PRSA – Personal Retirement Savings Account

PRSI – Pay Related Social Insurance

SSIA – Special Savings Incentive Account

SW – Social Welfare

1. Executive summary

Background (Chapter 2)

1.1 In February 2006 Séamus Brennan T.D., Minister for Social and Family Affairs, wrote to the Pensions Board ("the Board") and asked that 'the general principles in relation to a mandatory or quasi-mandatory [pension] system… [be] fully explored with a view to recommending the most appropriate system for Ireland at a practical level and to cost this'. This report is the Board's response to the Minister's request.

1.2 There are differing views among members of the Board of the rationale for and the merits or drawbacks of mandatory pensions, which were set out in the report of the National Pensions Review (NPR). This report is a technical examination of the practical issues associated with a mandatory pension system. It is not a recommendation by the Board for or against the introduction of a mandatory system. The views expressed in the report are the collective views of Board members and do not necessarily represent the views of nominating representative organisations. Furthermore, the collective recommendation was made notwithstanding that Board members may individually have other preferences.

Key objectives and policy context (Chapter 3)

1.3 One of the core objectives of the current agreed Programme for Government (2002) is to help all older people to live in dignity by implementing a coordinated programme of measures to address the full range of issues of concern to older people. Pension provision in Ireland has been subject to considerable analysis over decades, but particularly over the last year.

1.4 The Board, through the NPR in 2005, also examined the current Irish pensions system and made proposals designed to improve pension provision.

1.5 The new partnership agreement 'Towards 2016' includes a specific commitment that the Government and the social partners will work together to enhance pension provision and income supports and that future policy in this area will be considered in the context of the NPR, the outcome of the further work requested in relation to mandatory pensions, the publication of a Green Paper by the Government on pension policy and the views expressed by stakeholders including social partners.

1.6 The objectives of this report are both to explore the general principles of a mandatory system and to make specific practical recommendations.

1.7 In undertaking the project, a number of principles were agreed by the Board at the outset

(a) Ireland already has a good level of pension provision and a sound pension base and any changes should build on this. As far as possible, changes must not damage existing pension provision or worsen the existing position of any pension scheme.

(b) Any mandatory system should ensure both adequacy and coverage objectives are met.

(c) In considering how the system would be introduced any adverse effect on the current system of pension provision will need to be minimised.

(d) The costs, economic impact, and effect on competitiveness of any model being considered will be examined as fully as possible.

(e) Any recommendations made must be practical, capable of implementation, and likely to further the objectives of the mandatory approach.

Approach and background (Chapter 4)

1.8 The approach adopted in this report is to identify different types of mandatory system and, within each type, to define and specify the important parameters. These specific systems are then subjected to quantitative and qualitative assessment.

Overview of mandatory systems (Chapter 5)

1.9 The most basic choice in a mandatory system is between an extension of the current State pension and the creation of an additional mandatory supplementary pension. As part of this project, the Board considered both approaches in depth.

1.10 A number of countries have introduced mandatory supplementary systems in the last 25 years. Among the best known examples are Australia, Chile, Singapore, Sweden and Switzerland.

1.11 The Board commissioned

- Life Strategies, a firm of actuarial consultants, to provide projections of the effect of a number of pension systems.
- The Economic and Social Research Institute (ESRI) to quantify the macro-economics for Ireland of the introduction of the various types of mandatory pension systems examined. The ESRI used their medium-term model HERMES to simulate the economic effects of alternative

pension systems on macroeconomic variables such as Gross National Product (GNP), employment and unemployment. The medium term effects were then used by the Board in the long-term modelling by Life Strategies of the alternative systems.

- Fitzpatrick Associates to assess the likely broad economic impacts of the introduction of a mandatory pension system in Ireland, including the impact on discretionary savings, fiscal balance/national savings and competitiveness; the labour market effects of compulsory savings; and the prospective implications of the proposed system on potential economic growth rates.

The Board recognises that additional economic and projection of any proposed system would be of benefit.

1.12 The ESRI's modelling projected that any alternative system would have a negative impact on GDP and GNP growth and employment. It also projected a negative effect on real disposable income, wages and balance of payments. The level of impact on each of the macroeconomic variables differed from system to system.

The Fitzpatrick's study indicates that while mandatory pension contributions can negatively impact on the labour market, with repercussions in terms of national competitiveness and overall economic growth, a scheme could, with appropriate design and delivery, increase overall levels of saving.

It should be noted that there are differences between the projections of ESRI modelling and the report by Fitzpatrick Associates about the effect of mandatory pensions on the national savings ratio.

1.13 Having considered international experience, and the differences in the prevailing Irish economic and social situation, the report deals with particular mandatory pension systems which have potential for being introduced in Ireland, that is a first pillar, second pillar and a hybrid scheme as well as a soft mandatory option.

First pillar model (Chapter 6)

1.14 Chapter 6 considers whether the objectives of mandatory pension provision could be achieved by an increase in the contributory State pension.

1.15 The specific model examined in detail was based on the assumption of an increase in the amount of the State pension from its 2006 level of about 33% of Gross Average Industrial Earnings (GAIE) in 2005, to 50%, or from the current amount of about €193 per week to about €300 in 2006 value. It is assumed in the costings that the pension is increased from its current level to the target level over a period of ten years, and its level maintained as a proportion of GAIE thereafter through an explicit link between the State

pension and earnings increases. It is also assumed that anyone receiving a contributory State pension will be entitled to the increased State pension amount, irrespective of when they retired. Voluntary pension provision would continue as at present although some impact on the level of voluntary pension provision in light of the scale of the increase in the State Pension could be expected.

1.16 The economic impact and cost projections of this system are contained in chapter 6 as well as the other issues arising from such a model.

1.17 Increasing retirement benefits by increasing the State pension is conceptually and administratively straightforward, and the level of expense depends on the amount of increase being considered. Some of the aspects of such a system are worth highlighting

(a) Any increase in the State pension will result in additional income for those who have already retired as well as for future pensioners. Redistribution will therefore occur between the current generation of workers and those who have already retired or who will shortly retire.

(b) An increase in the State pension will not result in any additional administrative cost, as it will not cost the Department of Social and Family Affairs any more to administer the increased pension payments.

(c) Unless the cost of the increase is fully met from additional contributions, the result of an increase will be that the Exchequer will be providing an additional benefit to all pensioners, irrespective of whether they need it or not. This may be seen as a less efficient use of those resources compared to a more targeted approach and would give rise to significant opportunity costs in terms of overall public expenditure.

(d) If people are obliged to make additional contributions in return for an increased State pension, they will want reassurance that the State will have the capacity to provide the promised level of the State pension. However, the State pension amount is set by the Government each year, and there are no long-term commitments about the level of benefit or any increase in the pension once paid, or even the age at which it will be paid or the qualification conditions. If additional contributions are to be charged, more definitive commitments may be thought necessary, which may have important implications in restricting budgetary flexibility going forward.

(e) An increase in the level of State pension would result in a reduction in contributions and benefits from supplementary schemes which have a Social Welfare offset. There might also be a reduction in

supplementary coverage resulting from the view that the higher State pension would provide adequate income.

Supplementary model (Chapter 7)

1.18 Chapter 7 examines a mandatory pension system which obliges qualifying earners to contribute to a funded supplementary system. Such systems are usually intended to provide contributors with retirement income above that provided by basic State provision.

1.19 The supplementary model chosen for analysis was as follows:

(a)	Eligibility	All employees and self employed (but see discussion of harmonisation in section 7.27 below).
(b)	Eligible income	All earned income between 200% and 600% of the State pension (between approximately €20,000 and €60,000 as at June 2006)
(c)	Benefit type	Defined contribution
(d)	Contribution rate	15% of eligible income
(e)	Exchequer contribution	5% (included in the 15% above). This would be in lieu of any employer and employee PRSI relief and of any employee tax relief on contributions
(f)	Pre-retirement access	None

Contributions would increase gradually from zero to the full amount in the ten years after introduction. Those with adequate existing provision would be exempted from the mandatory scheme. Additional voluntary provision would be allowed on top of the mandatory scheme.

1.20 The economic impact and cost projections of this system are contained in chapter 7 as well as discussion of the issues arising from proceeding with such a model.

1.21 The design of a mandatory supplementary pension system is extremely complex. There are a large number of decisions which must be made about many aspects of the new pension arrangements and their interaction with existing pension provision before a detailed implementation recommendation can be made. The most significant issues which require detailed examination are set out below.

(a) A mandatory supplementary system will require significant new structures to be created, including:

- Contribution collection and supervision mechanisms
- Compliance monitoring
- Harmonisation arrangements for existing schemes.

Most Board members thought it unlikely that the cost of these structures could be recovered from contributors. Furthermore, depending on the model chosen, these structures could involve some element of operational risk, which could possibly be substantial. It has to be decided whether the resulting eventual improvement in contributors' retirement provision justifies this effort.

(b) If existing pension provision is to be protected and encouraged to continue, it is inevitable that relatively complex harmonisation rules will be needed. It is not certain that these rules would work effectively to ensure the successful knitting together of current voluntary and future mandatory supplementary pension saving.

(c) A fundamental decision is how much contributors will be exposed to market investment and its resulting volatility: the alternative may be some form of State guarantee or State investment management. The Board member nominated by the Minister for Finance believes that State guarantees would transfer unknown and unquantified risks onto the Exchequer and future taxpayers.

Soft mandatory models (Chapter 8)

1.22 There is a great deal of support in Ireland and worldwide for soft mandatory or automatic enrolment pension systems. A soft mandatory system can be defined as a pension system where eligible workers are obliged to join, but they have the right to opt out and cease contributing if they wish.

1.23 It is planned to introduce soft mandatory savings schemes in New Zealand (the 'KiwiSaver') and in the U.K. (the National Pensions Savings Scheme, or NPSS). An outline of these proposals is provided in Appendix C.

1.24 The model chosen for analysis was as follows:

(a)	Eligibility	All those beginning employment on or after the date of introduction of the scheme who do not become members of occupational schemes immediately on beginning employment. There would be no obligation for those who are self-employed to join, but those who wished could.

		Those in employment at the date of introduction of the scheme would also have the option of joining.
(b)	Employee contribution	5% of income
(c)	Employer contribution	2% of income
(d)	Exchequer contribution	2% of income, to a maximum contribution of €750 p.a.
(e)	Opt-out	Contributors could cease contributions after three months' contributions had been made. No immediate refund of contributions would be allowed in the first year. Employer and Exchequer contributions would be returned to them rather than to the employee. All employees who would be eligible to join on beginning employment would be allowed to recommence contributions at any time on one month's notice
(f)	Access to funds	Contributors would be allowed to access 25% of their funds tax-free on one occasion before or at retirement.

1.25 The principal implementation issues for a soft mandatory scheme are

- The number of participants in a soft mandatory scheme as described here will be smaller than a fully mandatory scheme. The approach adopted for contribution collection is therefore more likely to be an adaptation of an existing system than a new creation.

- The biggest compliance problem is likely to be employers and employees colluding to avoid the scheme. Supervision of compliance would be challenging.

1.26 A soft mandatory system is much less likely to be disruptive of existing occupational pension arrangements than a mandatory supplementary scheme as outlined in chapter 7.

1.27 It is extremely difficult to predict the take-up of a soft mandatory system: the success of such a system will depend on how effective the promotion of such a system is and how much it captures the interest of potential savers.

Hybrid model (Chapter 9)

1.28 It was decided to examine a proposal that would incorporate elements of both first pillar and supplementary mandatory systems to see whether a combined approach offered advantages over one or other alternative.

1.29 The hybrid system examined comprises an increased State pension as well as a mandatory supplementary system. The proposed increase in the State pension was a 20% increase over the current level. This would increase the pension from the current level of 33% of GAIE to 40%, and in current values, would increase the weekly pension from €193 to €232.

In addition to the increased State pension, a mandatory supplementary system would operate as follows:

(a)	Eligibility	All employees and self employed
(b)	Eligible income	All earned income between 125% and 500% of the increased State pension (between approximately €15,000 and €60,000 as at June 2006)
(c)	Benefit type	Defined contribution
(d)	Contribution rate	15% of eligible income
(e)	Exchequer contribution	5% (included in the 15% above). This would be in lieu of any employer and employee PRSI relief and of any employee tax relief on contributions
(f)	Pre-retirement access	None

It is assumed in the costings that the pension is increased from its current level to the target level over a period of ten years, and its level is maintained as a proportion of GAIE thereafter. It is also assumed that anyone receiving a contributory State pension will be entitled to the increased amount, irrespective of when they retired.

1.30 The economic impact and cost projections of this system are contained in chapter 9 as well as the advantages and disadvantages of proceeding with such a model. The implementation issues identified in chapter 7 for a mandatory supplementary scheme also arise for this model: indeed,

because the mandatory supplementary contributions under this system are greater than under that described in chapter 7, these issues are of more importance under this system.

Conclusion and recommendation (Chapter 10)

1.31 This report recommends that the most appropriate and practical approach to improving the position of pensioners in Ireland would be a combination of an increase in the State pension with a mandatory supplementary system for those at work who are not making supplementary provision. The system would be known as the Special Savings for Retirement (SSR) and individuals would hold Special Savings for Retirement Accounts or SSRAs.

This recommendation is being made in response to the specific request of the Minister for Social and Family Affairs in his letter to the Board of 6 February 2006. It is not a recommendation for or against the introduction of such a system. Furthermore, the collective recommendation was made notwithstanding that Board members may individually have other preferences.

The Board member nominated by the Minister for Finance believes that owing to such factors disclosed in the report as the significant Exchequer costs, the broader macroeconomic effects and the prospective adverse impact on existing voluntary provision, the Board's recommendation does not comprise a workable option.

1.32 The report specifically recommends that the contributory State pension be increased to 40% of GAIE over ten years until 2016 or similar period, and that the real value of the pension be maintained at least at that proportion of GAIE thereafter.

1.33 In addition, it is recommended that a supplementary system called Special Savings for Retirement be set up for all employees who are not members of occupational schemes or do not have sufficient supplementary savings.

The detailed provisions of the scheme are similar to those described in chapter 9 and are as follows:

(a) Eligibility — All employees and self employed who are not members of an approved pension arrangement or do not have sufficient supplementary savings would be automatically enrolled to the Special Savings for Retirement scheme (see 10.9(b) below)

(b)	Eligible income	All earned income above 50% of GAIE (approximately €15,000). An upper limit of no less than 200% of GAIE is recommended (approximately €60,000) though a limit of €90,000 was also suggested.
(c)	Total contribution rate	15% of eligible income. The split among employee/employer/Exchequer to be agreed as part of partnership.
(d)	Benefit type	Defined contribution (but subject to a minimum – see 10.9(f) below)
(e)	Access to funds	There would be no pre-retirement access to funds except in specified exceptional circumstances.

The mandatory contributions to the SSR would be introduced gradually over 10 years.

The projected costs of this system are summarised in chapter 9 and given in considerable detail in Appendix E.

1.34 The primary reasons why the above system is being proposed are as follows:

(a) There is considerable support amongst the Board for an increase in the State pension as a means of improving retirement incomes for all existing and future retirees. The increase proposed above is intended to balance the considerations of improved retirement income and sustainability.

(b) Because the proposed improvement in the State pension would be felt by many to be an inadequate retirement income, additional provision would be made through obligatory contributions to a supplementary savings scheme.

1.35 Some brief comments on the other systems considered are:

(a) Although there is much support for the increase in State pension to 50% of GAIE as examined in chapter 6, the projected costs are seen to be a significant difficulty.

(b) A mandatory supplementary system as described in chapter 7 will eventually deliver benefits close to the NPPI targets. However, such a system would take about 40 years to provide full benefits, and raises considerable issues of implementation and design complexity,

although these issues also arise to some degree in relation to the Board's preferred option.

(c) Although there is much support in a soft mandatory system as described in chapter 8, there is concern that the take-up of the supplementary provision would be too low to achieve the desired objectives. It would however have the advantage of facilitating individuals in making their own retirement savings decisions.

1.36 The following is a summary of the observations on the Board's recommended mandatory system made by Fitzpatrick Associates in their report.

- Potentially highest costs of implementation
- Still some potential for negative external perceptions of additional 'taxation'
- Labour market impact more significant than purely supplementary scheme
- Guarantees greater minimum income in retirement
- Guards against regressive impacts with lower income threshold
- Stops higher income groups from using scheme as alternative investment option

The full text of their report is given in Appendix A.

1.37 Any change to supplementary pensions can potentially increase complexity and may have unintended consequences. The Board would therefore be in favour of further study of the detailed implementation of the supplementary mandatory system proposed, in combination with appropriate public consultation before the system could be introduced.

A number of relevant implementation issues were identified in chapters 6 and 7. The Board's current views on these topics are:

(a) A number of the Board members are in favour of increasing the contribution to the NPRF sufficiently to cover the entire long-term cost of the increase in the State pension. The amount of this increase is estimated to be about an additional 1.3% of GNP, or about €1.7 billion per annum. However, other Board members are not in favour of pre-funding these payments.

(b) Those making existing adequate occupational pension provision or who have sufficient savings would not be required to contribute to the

SSR scheme. Detailed regulations would be required to define what would constitute adequate alternative provision and appropriate certification procedures would have to be designed and supervised.

(c) The Board's initial view favours the use of the PRSI system for collection of contributions, but recognises that considerable further investigation is needed.

(d) There is a range of views about what the upper limit for eligibility should be. There is some support for setting this limit at 3 times GAIE or approximately €90,000.

(e) The Board's initial view favours the investment of contributions by the State, possibly through the National Treasury Management Agency.

(f) Some Board members believe that it would be appropriate to provide investment guarantees for contributions to the SSR scheme. Such guarantees could provide a minimum investment return, or could ensure a minimum retirement income.

(g) The Board notes that the introduction of the Special Savings for Retirement system would require an increase in the regulatory resources required for ensuring compliance. This may include some or all of the Pensions Board, the Financial Regulator, the Revenue Commissioners, the Department of Social and Family Affairs, and possibly other bodies.

1.38 The Special Savings for Retirement system outlined in this report could improve retirement incomes for all existing and future retirees and encourage additional saving for retirement by those in the workforce.

1.39 The Board believes that the operation of the scheme should be carefully monitored so that any changes can be made in light of progress towards objectives and changes in circumstances affecting pensions. This may be the case if the scheme has any unforeseen effects.

1.40 While further consideration will need to be given to some of the implementation issues, the report provides a realistic picture of the practical implications of introducing such a system from a range of perspectives. In conjunction with the findings of the NPR, the Board believes that the up-to-date costs and projections shown in this report and its conclusions and recommendations will make a sound contribution to future decision making on pension provision.

2. Background

2.1 In a letter dated 6 February, 2006, Séamus Brennan T.D., Minister for Social and Family Affairs, asked the Pensions Board (the Board) that 'the general principles in relation to a mandatory or quasi-mandatory [pension] system… [be] fully explored with a view to recommending the most appropriate system for Ireland at a practical level and to cost this'. The letter also asked that the consideration by the Board should fully explore 'the extent to which the State can, or indeed should, guarantee returns when it requires them to contribute to a pension scheme.' This report is the Board's response to the Minister's request.

2.2 There are differing views among members of the Board of the rationale for and the merits or drawbacks of mandatory pensions, depending on what type of mandatory system is under discussion. These views were set out fully in the report of the National Pensions Review (NPR), and are not revisited in this document.

This report is a technical examination of the practical issues associated with mandatory pension systems, and, in accordance with the request of the Minister, it considers what would be the most appropriate system, were a decision taken to introduce a mandatory system. This report is not, therefore, a recommendation by the Board for, or against, the introduction of such a system as there is no consensus on the Board on this issue. Rather, it seeks to set out the main social, economic, budgetary and practical implications of introducing what would appear to be the most appropriate system for Ireland should the Government decide to proceed along the mandatory route to better pension coverage and adequacy.

The views expressed in this report and in particular in the Conclusion and Recommendation (chapter 10) are the collective views of the Board members and do not necessarily represent the views of nominating representative organisations. Furthermore, the collective recommendation was made notwithstanding that Board members may individually have other preferences.

2.3 The Government is committed to

(a) publishing a Green Paper on Pensions Policy outlining the major policy choices and challenges in the pensions area, and

(b) responding to the consultations on foot of the paper's publication within 12 months of the ratification of the new partnership agreement, by developing a framework for comprehensively addressing the pension agenda over the longer term.

This is a key development which provides a vehicle for individuals or organisations to contribute views and information, and for a range of proposals to be considered by Government in relation to pensions planning. With regard to this report, it provides the context for consideration of all future policy in relation to pensions, including consideration of the issue of compulsory saving.

This report is presented as a contribution to the policy debate which will now take place. While further consideration will need to be given to some of the implementation issues, the analysis provided in this report, and our other reports, including the NPR, should provide a sound basis for the preparation of the Green Paper and Government decisions on pension provision. The Board looks forward to assisting with the Green Paper process and is available to provide elaboration on any issues contained in this report, as appropriate.

3. Key objectives and policy context

3.1 One of the core objectives of the current Agreed Programme for Government (2002) is to help all older people to live in dignity by implementing a coordinated programme of measures to address the full range of issues of concern to older people. Similar objectives have been agreed by the social partners in successive national agreements. State pensions for older people have increased by almost 100% in less than a decade, significantly ahead of increases in the Consumer Price Index and gross earnings over the same period. Although considerable progress has been made in the level of the State pension, neither the level of State pensions, nor the coverage or adequacy of occupational and personal pensions have reached the targets set out in Government programmes, national agreements or Board reports over the years. It is however important to note in assessing progress in achieving coverage targets that a significantly greater number of people are now covered by supplementary pension arrangements reflecting the very strong growth in employment over recent years and record employment levels overall.

Pension provision in Ireland has been subject to considerable analysis over decades, but particularly over the last year. The Economic and Social Research Institute (ESRI) has undertaken an assessment of age-related pressures on the public finances from 2005 to 2050. The Organisation for Economic Cooperation and Development (OECD), in both their "Economic Survey of Ireland 2006" and their report on ageing and employment policies in Ireland published at end 2005, commented on the need for further reform; while the International Monetary Fund (IMF) report on Ireland in October 2005 welcomed further consideration of policy responses given concerns that households on the whole are not saving enough for retirement. These reports recommended a number of important measures that could be taken to address the challenge of population ageing in Ireland. However, these recommendations are not considered in this report owing to its specific focus on the design of a mandatory pension system.

The National Economic and Social Council report "Strategy 2006: People, Productivity and Purpose", prepared in conjunction with the social partners as an input into the 2006 social partnership talks, also pointed to the need for a more effective overall pensions system. It identified that a key question in this regard is whether to continue with the voluntary tax supported approach to earnings replacement, or to adopt an alternative approach such as a State earnings-related pension or the adoption of a mandatory savings approach.

National Pensions Review (2005)

3.2 The National Pensions Review (NPR) carried out by the Board in 2005 examined the current Irish pensions system with particular reference to the targets set out in the National Pensions Policy Initiative Report (NPPI) of 1998, "Securing Retirement Income". The NPR concluded with a set of proposals designed to deliver on the Government commitment to ensure an adequate retirement income for all.

The principal areas covered by the NPR included

(a) a review of the targets recommended in NPPI, including the main NPPI targets for coverage and adequacy

(b) a review of current levels of coverage and adequacy, taking State pension provision and occupational and personal pension provision into account

(c) policy issues relating to sustaining the first pillar (State pension) provision

(d) consideration of strategic options for meeting the NPPI targets i.e. various alternative national systems within the objective of achieving the targets

(e) consideration of possible enhancements to encourage greater take-up of supplementary provision and recommendation of specific enhancements by the Board

(f) views on possible mandatory pension provision. This set out the general considerations regarding a mandatory approach to achieving NPPI targets and outlined the views of Board members in that regard.

The key messages arising from the NPR are

(i) A significant increase in the annual costs of Social Welfare/State retirement pensions and public service pensions is predicted which is much greater than previously expected.

(ii) Good pension provision has a very high cost which arises however it is financed i.e. by employers, employees, self-employed, individuals or taxpayers through the Exchequer. The key question is therefore the distribution of those costs and ensuring that whatever approach is adopted is affordable from a fiscal perspective and consistent with the long-term sustainability of Ireland's economic performance.

(iii) Supplementary pension coverage is currently insufficient and is a cause for concern, notwithstanding the significant increase in

coverage in absolute terms. Furthermore, there does not appear to be any improvement in the adequacy of pension provision.

(iv) Most Board members agreed that pension coverage and adequacy targets will not be met without some change to the present pension system.

(v) The Board recommended specific changes to the current voluntary supplementary system and, in addition, some – but not all – members of the Board believed that the only certain way of achieving the supplementary coverage and adequacy targets would be to adopt a mandatory approach to pension contributions. The Board had insufficient time at that stage to thoroughly investigate and cost the many possible approaches but gave some information on five possible scenarios.

The NPR report was publicly launched by Mr Séamus Brennan T.D., Minister for Social and Family Affairs, in January 2006. In doing so, the Minister welcomed the document as a very comprehensive report that would be a valuable contribution to the future design and delivery of pension reforms. While welcoming the proposals for enhancements to the voluntary system and their undoubted scope to deliver increased pensions coverage, he also felt that the introduction of a mandatory or quasi-mandatory system should be further explored. Arising from a national debate, including discussions within the social partnership process, on the issues raised in the NPR report, the Government would, he indicated, in time reach conclusions on the various proposals and seek to achieve a consensus on how best to lay the foundations for future retirement security for everyone.

The NPR included a specific recommendation that individuals would have the option on deferring their State pension in return for a higher pension beginning at a later date. This is intended to remove one of the barriers to working longer for those who choose to, without affecting the rights of those who do not. The Minister has asked his officials in the Department for Social and Family Affairs to investigate this matter further.

Developments 2006

3.3 The main developments since the NPR which are relevant to this report are set out below, including the Finance Act 2006, the National Pensions Forum (May 2006), and the new partnership agreement “Towards 2016” (proposed National Agreement, June 2006)*.

* It will not be known until September 2006 whether Towards 2016 has been ratified by all the various parties

Since the launch of the NPR, the Finance Act 2006 included changes to the tax system designed to encourage lower income holders of Special Savings Incentive Accounts (SSIAs) (whether within or outside the tax net) to transfer their maturing SSIA funds into pension provision, as well as measures to increase for older workers (aged 55 or over) the tax relief available on contributions to pension provision.

On 5 May 2006, the Minister called together all parties interested in pension reform to a National Pensions Forum to consider the central issues and to hear the views of all stakeholders on the way forward, including public representatives, social partners, industry representatives and those representing the interests of pensioners. While the main purpose of the Forum was to hear the views of stakeholders on the conclusions of the NPR, speakers were also invited to outline major reforms proposed or undertaken in other countries. The Forum provided the opportunities for a wide range of views to be explained and considered.

Towards 2016

One of the most important pension developments in 2006 to date was the completion of the partnership talks in June 2006. The multi-dimensional nature of the question of pension provision is reflected in the proposed new national partnership agreement. While "Towards 2016" does not contain any commitment to introduce mandatory pensions, it does highlight the commitment of the Government and the social partners to working together over the next ten years towards the following relevant goals and actions:

(a) Every person of working age would have an income level to sustain an acceptable standard of living and to enable them to provide for an adequate income in retirement.

(b) Support adequately all people of working age, whether in the labour force or out of it, through the social protection system. Elements of social protection will be examined to ensure that atypical working, the reconciliation of work and family life and those working on low incomes are supported.

(c) Every older person would have access to an income which is sufficient to sustain an acceptable standard of living. Specific actions include enhancement of Social Welfare pensions and qualified adult allowance for pensioner spouses, finalisation of the deliberations of the Working Group on Administrative Individualisation and enhancement of the social insurance system to reflect the contribution of farm spouses.

(d) Provide an adequate income in retirement which, as far as possible, is related to pre-retirement income.

(e) Enhance the level of occupational pension coverage. The social partners will co-operate to promote improvements in the coverage of pension schemes towards the agreed NPPI target of 70% of the total workforce over age 30.

Actions are also included regarding a partnership pensions review, timeframes for a Green Paper on National Pensions Policy and transposition into Irish law of the optional pension provisions of the EU's Transfer of Undertakings Directive.

The agreement includes a specific commitment that the Government and the social partners will work together to enhance pension provision and income supports and that future policy in this area will be considered in the context of the NPR, the outcome of the further work requested in relation to mandatory pensions, the publication of a Green Paper by the Government on pensions policy and the views expressed by stakeholders including the social partners. The parties are agreed that in order to promote the achievement of the pensions objectives and aspirations set out in the agreement they will actively co-operate both at national level (e.g. under the auspices of the Board) and at workplace level.

Process for devising a mandatory system

3.4 The NPR identified that some Board members believed that a mandatory approach is the only certain way of achieving the NPPI targets, while others believed that the cost of the certainties which can be provided by a mandatory supplementary pensions system is too great in terms of macroeconomic, budgetary and other impacts, including the effect on existing provision. Ultimately this is a decision for Government to make, having regard to a range of social, economic and fiscal considerations, including the perspective of the Board.

In February, the Minister for Social and Family Affairs wrote to the Chairperson of the Board, Mr Tiarnan O Mahoney, asking that the principles in relation to a mandatory or quasi-mandatory pension system would be explored with a view to recommending the most appropriate system for Ireland at a practical level, were the Government to proceed in this direction.

The Board, at its meeting of 20 March, 2006, agreed to undertake a technical exercise to devise a number of possible mandatory pension systems, and to seek to identify the most appropriate as requested by the Minister. It is not intended that this exercise will revisit the principle of mandatory pension provision, but will focus on what such schemes might look like and the impact of introducing such schemes in terms of costs, long-term fiscal and economic performance, etc., if it were decided that this

was the best way of achieving the objectives of the national pensions strategy. This exercise, therefore, will include

(a) a background to the recommendation made, including environmental factors, principles and criteria used

(b) a proposed mandatory/quasi-mandatory pension system

(c) a projection of the contribution costs of the system to workers (whether employed or self-employed), employers and the Exchequer, and

(d) a commentary on the expected macro impact and on the anticipated effects of the system on existing pension provision.

Having regard to the extensive consultation process which had taken place in the context of the NPR, a workshop for Board members was held at the outset of the project with a view to identifying the key issues at the earliest possible stage. An Oversight Committee was also established to oversee the project and to act as a source of feedback and commentary to the project team. The following were appointed to serve on this:

Tiarnan O Mahoney – Chairperson of the Pension Board and of the committee

William Beausang – Department of Finance

Rosheen Callender – Irish Congress of Trade Unions.

Marie Daly – Irish Business and Employers Confederation*

Brendan Kennedy – Board Executive

Anne Maher – Board Executive

Jerry Moriarty – Board Executive

Anne Vaughan – Department of Social and Family Affairs

Fergus Whelan – Irish Congress of Trade Unions

Yvonne White – Board Executive.

(*Irish Business and Employers Confederation withdrew its representative on 10 May, 2006)

The Oversight Committee met on three occasions and the report was considered by the full Board at its meeting on 26 June, 2006.

Consultancy support in the areas of costings, economic effect and the effect of a mandatory regime on current pension provision was also sought and provided by Life Strategies, the ESRI, and Fitzpatrick Associates.

Relevant NPR conclusions in relation to mandatory pensions

3.5 The NPR considered the role of mandatory pensions in meeting coverage and adequacy targets and concluded that any mandatory system could be structured to achieve any given set of targets in this regard, although the adequacy targets established in the NPPI will have significant economic and financial implications regardless of whether they are achieved through voluntary or mandatory means. The main NPPI targets are a replacement income of 50% of gross pre-retirement income, a minimum State contributory retirement pension of 34% of Gross Average Industrial Earnings (GAIE), and, in order to achieve this, a supplementary pension coverage rate of 70% of those aged 30 and over.

The NPR concluded that proposals for a mandatory private sector system would have to be assessed in the light of judgements on

(a) the ability of the pensions industry to provide a fair, comprehensive, competitive and comprehensible service to a largely financially-unsophisticated public

(b) the implications for the present system of tax relief

(c) the effects on other forms of saving nationally, and

(d) the possibility of the element of compulsion involved generating claims of State liability to make good shortfalls in the event of losses suffered by participants, not only on the collapse of individual schemes, but also in the normal year-to-year operations of the various schemes.

The case made for a mandatory State-run system would have to take account of

(i) the cost of the system to the Exchequer

(ii) the implications for the saving and financial services industry generally, and

(iii) the degree of State liability entailed in compulsion to join a State-run pension system.

The NPR also outlined a number of alternatives to moving immediately to a full mandatory system, including

1. introducing a mandatory system with a long lead-in time.

2. gradual increases in the amount of mandatory contribution building up to the target rate, easing contributor adjustment to the cost of the system.

3. gradual increases in the income subject to mandatory contribution. The potential drawback of this approach is that the impact of the system in the early years will differ significantly for different categories of people.

4. limiting the mandatory system to those entering the workforce, or those born after a certain year. Such an approach would have to avoid creating disincentives to the employment of those subject to the mandatory scheme, whereas a requirement for a minimum contribution level that is equal for all at least places all employees and employers on an equal footing.

5. a soft mandatory system of automatic enrolment, allowing for subsequent opting-out in specified circumstances.

The NPR identified that mandatory pension provision is one of a number of options for meeting NPPI targets and that in practice a combination of options may be required. Among the potential models for mandatory/quasi-mandatory pensions considered in this report will be the possibility of increasing contributions to provide increased first pillar/State pensions.

As described in chapter 2, this report does not deal with the question of comparison of mandatory systems with non-mandatory alternatives as a means of achieving pension objectives. This report is a technical examination of the practical issues involved in designing and implementing some form of mandatory system.

Principles

3.6 In undertaking the project, a number of principles were agreed by the Board at the outset:

(a) Build on a sound base: Ireland already has a good level of pension provision and a sound pension base and any changes should build on this rather than adversely affect the existing system of voluntary supplementary pension provision. Moreover, Ireland already has one mandatory pension system in the form of the Pay Related Social Insurance (PRSI) based contributory State pension. This exercise is concerned with a mandatory pension system intended to provide a retirement income greater than that which is minimally necessary to avoid poverty. As far as possible, changes must not damage existing pension provision or worsen the existing position of any pension scheme – employer involvement in good quality pension provision should be maintained and encouraged.

(b) Ensure both adequacy and coverage objectives are met: The overall objective is to improve the situation with regards to pensions both in terms of coverage and the amount of pensions paid. A central consideration here is the level of inclusiveness, since a system could apply only to employees or might include the self-employed; it could include the private sector or both private sector and public sector; it could be limited to earners above or below certain ages; and there may be other eligibility rules, for instance exempting smaller employers. It is also likely that income below a certain minimum would not be included, and that there would be an upper limit. Ultimately, any new system will be aimed at overcoming the effects of inertia, interrupted careers and other factors which have contributed to low levels of coverage. Furthermore it must be capable of coping with the increase in atypical employment patterns and the shift away from traditional employment patterns that underlie much current pension scheme design. The model should be capable of delivering a significant increase in participation in pension savings to provide an appropriate standard of living and quality of life in retirement.

(c) Plan implementation and identification of any barriers which exist: In considering how the system would be introduced, depending on whether it would cover all eligible individuals or merely new entrants, the effect on the current system of pension provision will need to be considered. Consideration will need to be given to changeover costs, as appropriate. Continuity will need to be planned for, given the long-term nature of pensions, including an assessment of whether the system being examined is similar to the current system and whether any changes can be reasonably easily accommodated. Any system being considered must be robust enough to deal with future events and as transparent and simple as possible if it is to be accepted by the widest number of people.

(d) Count the costs and benefits: The costs and economic impact of any model being considered will be examined as fully as possible, as well as the social benefits and socio-economic impact. The effects on workers, employers (where relevant) and on the Exchequer will be separately assessed and considered. Overall affordability from a budgetary perspective is a key consideration to ensure the long-term sustainability of Ireland's fiscal and competitive position.

(e) Provide a practical solution: Any recommendations made must be practical, capable of implementation, and likely to further the objectives of the mandatory approach.

The following chapters explore in more detail potential models for mandatory pension provision in the Irish context, having regard to the objectives and principles outlined above.

4. Approach and background

4.1 The objectives of this report are both to explore the general principles of a mandatory system and to make specific practical recommendations. To this end, the approach adopted by the Board was as follows:

(a) Different types of mandatory system were identified for examination, having regard to international experience and prevailing and expected future Irish conditions.

(b) Within each type of mandatory system, the main parameters were identified and values specified. The resulting systems were examined, costed in detail and economic impacts considered.

(c) A comparison of the differing specific proposals was then made and a recommendation identified.

Chapter 5 identifies the different classes of mandatory system and considers the differences between them. The following chapters then define and examine a specific proposal from each system. Chapter 10 identifies the Board's recommendation within the context of the project.

Coverage and adequacy

4.2 One of the most important criteria against which different systems will be judged will be their effectiveness in improving pension coverage and adequacy as compared with, for instance, the NPPI objectives. It is therefore useful to examine the information available about current coverage and adequacy. This can then be used as a basis for comparing alternative systems.

Table 4.2.1 shows the pension coverage data from 2004 for employed and self-employed, analysed by age, gender and weekly income. These data have been provided by the Central Statistics Office (CSO) from the EU-SILC survey, and are the most recent available.

Table 4.2.1 – pension coverage in 2004 for persons aged 20 to 69 and in employment

Decile	Income per week €	Average pension coverage %	Male pension coverage %	Female pension coverage %	Females as % of total in decile	Average age
1	0-139.99	9.5	12.7	7.7	64	41.5
2	140.00-241.47	20.4	16.6	22.4	66	41.4
3	241.48-325.80	29.0	25.9	31.1	59	38.3
4	325.81-398.05	37.6	30.8	44.5	50	38.1
5	398.06-466.83	49.6	45.1	54.7	47	37.7
6	466.84-549.53	50.8	48.0	56.2	34	39.5
7	549.54-651.59	67.0	63.4	73.3	36	39.6
8	651.60-794.39	73.9	72.6	77.7	26	41.7
9	794.40-1034.88	81.8	82.0	81.5	29	43.3
10	1,034.89+	87.1	86.3	89.9	22	45.5
Total		50.6	54.9	45.0	43	40.7

Income is defined in the above table as the sum of gross employee and self-employed income.

Note that the State pension in 2004 was €162 per week.

There is no aggregate measure of pension income adequacy relative to NPPI or other targets comparable to that for pension coverage. However, Table 4.2.2 shows an approximate analysis of the types of pension coverage at the end of 2005, based on data from the Board's register, Personal Retirement Savings Account (PRSA) data and CSO surveys.

Table 4.2.2 – approximate analysis of pension coverage

	%
Occupational defined benefit – private sector	27
Occupational defined benefit – public sector	29
Occupational defined contribution	26
RACs, PRSAs	19
Total	100

In the above table, those defined benefit schemes subject to the funding standard are assumed to be private sector, and those not subject to the standard are assumed to be public sector. The assumption is not quite accurate in all circumstances but is believed to be reasonable for these purposes.

Although adequacy for each individual is different, the following broad classifications may be useful as a very rough guide to adequacy as defined by reference to the NPPI targets – note that the assessment of adequacy includes State pension:

Public service DB	Most members of these schemes are likely to meet the NPPI targets for retirement income adequacy.
Private sector DB	Although there is variation in scheme benefits, members with long service with a single employer are likely to meet NPPI adequacy targets. Those with frequent changes of employment are less likely to achieve adequacy.
Private sector DC	Based on consideration of typical contribution rates, it is unlikely that most will achieve NPPI adequacy.
PRSAs and RACs	Although data are fragmented and incomplete, it appears unlikely that many will achieve adequacy, except among pension-aware high earners.
No provision	Those earning less than €20,000 p.a. are likely to achieve the NPPI replacement targets by relying solely on the State pension. However, there are approximately 640,000 who will not achieve this target because of lack of supplementary provision.

Projections

4.3 The Board commissioned Life Strategies, a firm of actuarial consultants, to provide financial projections for a number of pension systems. The complete range of results and a commentary on the modelling used is included in Appendices D and E. The modelling approach used followed that adopted in the NPR, but there were some differences in assumptions, which are explained later in this report.

The Board has been asked to examine the costs of any mandatory system proposed. In any event, the Board is of the view that modelling of the costs and benefits of pension systems under consideration is essential in order to understand how such systems work and what the effects of them may be.

However, the limitations of such projections must be understood. The modelling of pension systems is necessarily long-term, and must include a considerable number of underlying assumptions. While it would be possible to perform the projections using other, equally reasonable assumptions, resulting in different projection outcomes, the approach taken, as far as possible, has been to ensure consistency with official forecasts from the CSO and Department of Finance. The projections are illustrations of what would be the impact of these pension systems, on the basis of a set of assumptions which, taken together, are considered to be reasonable.

4.4 The central basis used for the projections was based on that used in the NPR, and the details are provided in Appendix D. As well as this central basis, alternative projections were prepared in order to examine the robustness of the systems under examination under a range of different assumptions. These alternatives illustrate the possible effects of different migration assumptions and of different rates of investment return.

In addition to the bases described above, some additional projections were prepared which attempted to incorporate the economic effects of the pension system on the economic assumptions used. The results of these are included in this report, but further study is needed to improve these estimates.

5. Overview of mandatory systems

5.1 The Board has been asked to prepare a worked-out and costed model of a practical mandatory pension system, but has not been restricted by its terms of reference to any particular model. It has been frequently pointed out that Ireland already has one mandatory occupational pension system, namely the contributory State pension (known up to now as the contributory old-age pension). Therefore we are looking at what would effectively be a second supplementary mandatory system, or an extension of the first.

5.2 As part of this project, the Board considered both approaches in depth. These are explored fully in chapters 6 and 7. It is useful to first consider the differences of approach embodied in the two alternatives, particularly in terms of the redistributive effects, the relationship between contributions and benefits and funding issues, as well as pointing out some differences that can be reduced or eliminated.

(a) It is a primary objective of the State pension to be intentionally redistributive. The benefits that any qualifying contributor receives are not directly related to the amount of his or her contributions, or his or her employer's contributions, but primarily to the number of qualifying contributions made. The result is that there is a cross-subsidy from the better-off to the less well-off. This reflects the policy intention of this pension, which is to provide a basic income in retirement for the prevention of absolute poverty.

On the other hand, it is not an objective of existing supplementary pension provision to be redistributive, though some redistribution may occur in practice. Instead, a supplementary pension is intended to provide for retirement from the contributions of a participant and/or his or her employer, with assistance from the State in the form of tax incentives. In a defined contribution scheme, there may be some cross-subsidy of administration cost, but it is not likely to be significant. In a defined benefit scheme, there is cross-subsidy from those who contribute in times of better investment return to those whose contributions earn less. However, this cross-subsidy is better understood as risk sharing, and is not structural, insofar as it is not known from the start who will gain most. Within defined benefit schemes there is also an element of structural cross-subsidy towards those who retire on higher incomes, particularly to those who experience income growth late in their career, but it is probably fair to say that this subsidy is unintended.

(b) In supplementary pension provision, the benefits must in aggregate be related to the contributions made. In defined contribution schemes, the benefits are a direct function of the accumulated contributions and

the investment return earned. In defined benefit schemes, the contributions are calculated to be sufficient to provide the promised benefits over time: if it eventually appears that they will not be adequate, the benefits may have to be reduced and/or the contributions increased.

There is no actuarial relationship between the individual's aggregate contributions and the eventual benefits under the State pension. The amount of the benefits and of the contributions are political decisions, and if there is a shortfall in contribution income in any given year, the difference has been met by way of Exchequer contribution, although benefits could also be adjusted. In recent years there have been periodic actuarial reviews of the Social Insurance Fund in order to assess the likely proportion of PRSI contributions which should be earmarked for the pensions in the years ahead, although this is not performed for the purposes of setting the PRSI contribution rate.

(c) The State pension is now partially funded, i.e. assets have been intentionally accumulated to meet part of the future cost of the contributory State pension. These assets are held in the National Pensions Reserve Fund (NPRF), as recommended in the Board's 1998 Report "Securing Retirement Income". Part of the NPRF will also be used to meet part of the future costs of public service pensions, as recommended in the Report of the Public Service Pensions Commission (November, 2000). All private sector pension provision in Ireland must be funded in accordance with the Pensions Act.

The decision to put in place additional mandatory provision can be made separately from the decision whether or not to fund it. Any increase in the State pension could be fully or partially funded, or a decision could be taken to meet the future additional pensions on a Pay-As-You-Go (PAYG) basis i.e. from general taxation or on a shared-cost basis. If a supplementary mandatory system is preferred, it would be funded if the investment is via the private sector (see section 7.16). However, if the funds to be invested are paid to the Exchequer, a decision can be made whether or not to fund the benefits. If the scheme is to be funded, the Exchequer would invest the contributions and use the proceeds to provide benefits; if not, the State could collect contributions and keep track of entitlements, but use the contributions and pay the eventual benefits from general taxation. This latter approach would clearly increase the Exchequer's PAYG pension costs over time.

International examples

5.3 A number of countries have introduced mandatory supplementary systems in the last 25 years. Among the best known examples are:

Australia

Australia's mandatory system is funded by compulsory employer contributions (which have been phased upwards from 3% of eligible income in 1988 to 9% since 2002) and voluntary employee contributions. Employers must make a mandatory contribution of 9% for employees earning over AUD$450 (approximately €265) per month and although not required to contribute for workers earning less than AUD$450 monthly they can choose to do so. Funds are chosen by the employer subject to collective bargaining. Self-employed workers are not obliged to contribute. 90% of employees are covered by the supplementary pensions system.

Chile

Mandatory pensions were introduced in Chile in 1981. Employees pay 10% of salary, with contributions placed in individual accounts, but tax-deductible payments of up to 20% of salary are permitted. Employers are not obliged to contribute. The system is mandatory for all workers entering the labour market, although the self-employed are not obliged to participate. Upon retirement, workers can choose the form their provision may take – life-time annuity, programmed withdrawals, or temporary programmed withdrawals with a deferred life-time annuity.

Singapore

Singapore's system is publicly managed, operated through a portable nominal defined contribution system but is effectively operated on a PAYG basis. The Central Provident Fund (CPF) is the main vehicle for this system and is open to permanent residents and Singapore citizens. Employers and employees make monthly contributions to the CPF which go into three separate accounts – an ordinary account (for savings towards buying a home, paying for CPF insurance, investment and education), a special account (for old age, contingency purposes, and investment in retirement-related financial products), and a Medisave account (for hospital expenses and approved medical insurance). Contribution rates (which reduce upon reaching 50 years of age) are as follows:

- Private sector employees – 20%
- Private sector employers – 13%
- Public sector employees (non pensionable) – 20%

- Public sector employers (non pensionable) – 13%
- Public sector employees (pensionable) – 15%
- Public sector employers (pensionable) – 9.75%

CPF savings can be withdrawn at age 55, subject to setting aside a minimum sum which is used to buy an annuity, placed in a fixed deposit account, or left in the retirement account managed by the CPF Board. From age 62, monthly payments are made from the minimum sum. A voluntary Supplementary Retirement Scheme (SRS) complements the CPF.

Sweden

Employees contribute 7% of salary (up to a ceiling) and employers contribute 10.21% to the State Social Welfare system. The system is largely operated on a PAYG basis, but with a notional defined contribution concept where contributions paid by each individual define pension rights. 2.5% of contributions are paid into a personal, defined contribution plan known as the "Premium Pension": these contributions are invested in private sector managed individual accounts.

Switzerland

All employees earning over a minimum income (currently SFr 25,535 p.a. or approximately €16,400) must contribute towards a defined contribution pension plan – the BVG. Employed and self-employed persons who are not subject to mandatory cover can take out voluntary cover. Both employees and employers contribute to the plan with a minimum total contribution of 12% of the employee's salary. The BVG has an upper limit on the benefits it can pay (70% of final salary), so there is a ceiling above which pension contributions are not paid. Occupational schemes are established as foundations, separate from the employer's business and with employee and employer representation.

Economic impact

5.4 The level of contributions and benefits is as important as the type of system chosen although different mandatory systems would be expected to give rise to different macroeconomic effects depending on specific design elements. A mandatory system with significant contributions will have an economic impact, related to the level of contributions and the benefits provided.

The Board commissioned the ESRI to provide specific estimates of the impact of a number of mandatory systems. The detailed results of these projections are shown in the relevant chapters later in this report. The ESRI's modelling projected that any alternative system would have a

negative impact on GDP and GNP growth and employment. It also projected a negative effect on real disposable income, wages and balance of payments. The level of impact on each of the macroeconomic variables differed from system to system.

In addition, the Board commissioned Fitzpatrick Associates to assess the likely broad economic impacts of the introduction of a mandatory pension system in Ireland, including the impact on discretionary savings, fiscal balance/national savings and competitiveness; the labour market effects of compulsory savings; and the prospective implications of the proposed system on potential economic growth rates. This assessment was based on existing available international research literature and information, including the results of the economic modelling work undertaken by the ESRI for this review.

The Fitzpatrick's study indicates that the general view is that while mandatory pension contributions can negatively impact on the labour market, with repercussions in terms of national competitiveness and overall economic growth, a scheme could, with appropriate design and delivery, increase overall levels of saving. If these savings can be productively invested, expansions in national output can be generated. Overall, it is clear that the extent to which such impacts are realised is a product of the design and delivery of the system. The nature of its introduction, and especially a phased approach, are important in terms of the risk of potentially negative adverse effects on long-term economic performance.

Model	Issues for consideration
State pension of 50% GAIE (see chapter 6)	▪ Simplest and most cost effective to implement ▪ Perceived as additional taxation to a greater extent than a supplementary scheme ▪ Most likely to have greatest negative impact on national savings, compared to other models ▪ Resultant impact on labour force participation ▪ Impact on labour demand dependent on scale of increase in employers' PRSI contributions ▪ Less likely to impact on participation in voluntary pension schemes ▪ Approach may be perceived as overly

Model	Issues for consideration
	interventionist by potential inward investors
Supplementary scheme with 15% contribution (see chapter 7)	▪ More significant implementation costs ▪ Potential to generate increase in total aggregate savings, (although not guaranteed) ▪ May reduce contributions to voluntary pension schemes ▪ Less of a labour market impact than a PRSI based scheme ▪ Phased in rather than immediate approach may reduce impact ▪ Works most efficiently where balance exists between employers' and employees' contributions
Hybrid of increased State pension and supplementary system (see chapter 9)	▪ Potentially highest costs of implementation ▪ Still some potential for negative external perceptions of additional taxation ▪ Labour market impact more significant than purely supplementary scheme ▪ Guarantees greater minimum retirement income ▪ Guards against regressive impact with lower income threshold ▪ Stops higher income groups using scheme as alternative investment option

While international literature on the specific economic impacts of mandatory pension provision is limited, this study reviewed a range of material that provides good illustrative examples of the impacts that might result were such a scheme to be introduced. While direct application of such findings to the specific Irish context must be done cautiously, this report nonetheless serves as a means of identifying the economic issues that need consideration when making a decision with regard to mandatory pension policy

The full text of the Fitzpatrick Associates report is included as Appendix A

5.5 The Board recognises that additional economic analysis and projection of any proposed system would be of benefit. In particular, it should be noted that there are differences between the projections of ESRI modelling and the report by Fitzpatrick Associates about the effect of mandatory pensions on the national savings ratio.

5.6 Having considered international experience, and the differences in the prevailing Irish economic and social situation, the next chapters deal with particular mandatory pension systems which have potential for being introduced in Ireland, that is a first pillar, second pillar and a hybrid scheme as well as a soft mandatory option.

6. First pillar model

Overview

6.1 This chapter considers achieving the general objective of increased occupational pension provision by increasing the contributory State pension. It must be emphasised that this report is limited to considering pensions for those at work. Although the objective of the contributory and non-contributory State pension is to prevent poverty, this report only examines using the contributory State pension as a pragmatic means of increasing retirement income for those at work. Specific issues of income adequacy and relative poverty are outside its scope.

The EU Survey of Income and Living Conditions for 2004, published by the CSO in December 2005, identified the risk of poverty threshold in 2004 (i.e. 60% of median equivalised income per individual) as €185.51 p.w. Whether a person experiences poverty will depend on the degree to which income is below the threshold, the length of time spent on this income and the possession and use of other assets, e.g. family home. Social Welfare transfers reduce the risk of poverty for the 65+ age group from 87.4% to 27.1%, but older persons still had the highest risk of income poverty of all age groups in 2004.

6.2 The specific model examined in detail in this chapter is based on the assumption of an increase in the amount of the State pension from its current (2006) level of about 33% of GAIE in 2005 to 50%, or from the current amount of about €193 per week to about €300 in 2006 values. It is assumed in the costings that the pension is increased from its current level to the target level over a period of ten years, and its level maintained as a constant proportion of GAIE thereafter. It is also assumed that anyone receiving a contributory State pension will be entitled to the increased amount, irrespective of when they retired. Voluntary pension provision would continue as at present although some impact on the level of voluntary pension provision in light of the scale of the increase in the State Pension could be expected.

Current PRSI pensions

6.3 The retirement pensions provided under the current Social Welfare system are flat-rate payments, with eligibility based on achieving a certain level of social insurance contributions over a person's working life, or satisfying a means test. Payments based on social insurance contributions are financed by pay-related contributions made to the Social Insurance Fund by employers, employees and the self-employed, with any deficits being made up from general taxation. Social insurance pensions are independent of any other income or earnings a person might have. Recent initiatives to

extend social insurance coverage have resulted in growth in the proportion of pensions being paid on the basis of social insurance and it is projected that social insurance based payments will comprise some 86% of pensions in payment by 2016 (Actuarial Review of Social Welfare Pensions, 1997, by Irish Pensions Trust for the Department of Social, Community and Family Affairs).

Economic commentary

6.4 As part of this project, the ESRI were asked to assess the economic impact of this pension system using their HERMES economic model. Their full report in included as Appendix B.

The ESRI model is designed to project relatively small changes in economic circumstances over relatively short periods of time (i.e. up to five years). It cannot be used to provide projections over the 50 years covered by the Life Strategies calculations. Furthermore, it is likely to be less reliable in assessing pension systems, such as this one, where total contributions differ considerably from the current system. However, bearing in mind these caveats, it is nonetheless useful to consider the projected effects using the model.

Table 6.4.1 shows the projected effects of this pension system were it fully in place in five years, i.e. had the benefits and corresponding contributions reached their full amount. The table highlights the very significant impact on GDP, employment, earnings and disposable income of this option.

Table 6.4.1 – projected economic impact after 5 years

	% change
Real GDP	-3.3%
Real GNP	-0.9%
Employment	-3.1%
Unemployment Rate	+0.7%
Wages	-5.1%
Real Personal Disposable Income	-13.7%
Balance of Payments, % of GNP	+4.7%
Personal savings, % of disposable income	-2.5%

Costings

6.5 The tables below show the results of the projections of this system prepared by Life Strategies. These projections are on the NPR central basis. Details of this basis as well as projections on alternative bases are provided in Appendices D and E.

Table 6.5.1 compares the projected total benefits provided under this system with those projected under the current pension system. The benefits shown include all the occupational retirement pension benefits paid in each year including contributory State pension and private and public sector supplementary provision. All results are expressed as a percentage of GNP.

Table 6.5.1 – comparison of benefits, % of GNP

	2006	2016	2026	2036	2046	2056
Current	5.2%	6.7%	9.1%	11.8%	15.0%	16.6%
Increased SW	5.3%	8.4%	11.3%	14.4%	18.1%	19.9%

The projection of the current pension system shows the total amount of benefits increasing in the future as the numbers of people in retirement increase. The benefits shown for the increased Social Welfare pension scenario show an even greater increase, as a result of the increased State pension, though it should be borne in mind that the modelling assumes that the increase in State pensions will result in some reduction in supplementary provision – full details are provided in Appendix D. Because the increase is introduced gradually over 10 years, there is little difference between the 2006 figures for the two systems.

Based on a GNP total at the beginning of 2006 of €136 billion, the increase in 2016 between the total benefits under the current system and the model would be about €2.3 billion per annum in 2006 values.

The modelling assumes that a specific additional contribution is made in respect of the additional pensions. Table 6.5.2 compares the total pension contributions under the current system – that proportion of personal and employer PRSI contributions attributable to retirement pensions plus all contributions to supplementary pensions – with those under the mandatory system. This table shows these results as a percentage of GNP.

Table 6.5.2 – comparison of contributions, % of GNP

	2006	2016	2026	2036	2046	2056
Current	6.7%	7.0%	6.9%	6.8%	6.6%	6.6%
Increased SW	6.7%	8.6%	8.8%	8.7%	8.3%	8.3%

The total contributions under the current system show some increase as a result of a projected slight increase in the numbers in employment. This increase is gradually offset by the effect of the trend from defined benefit to defined contribution provision.

The projections for the alternative system show the effect from 2016 of the significant additional contributions needed to fund the increased State pension.

It is also useful to express the contribution costs as a percentage of workforce earnings as follows:

Table 6.5.3 – comparison of contributions, % of earnings

	2006	2016	2026	2036	2046	2056
Current	15.5%	15.5%	15.7%	15.7%	15.4%	15.4%
Increased SW	15.4%	19.2%	19.8%	20.2%	19.4%	19.4%

The projected amount of the additional contribution in 2016, expressed in 2006 values, is about €2.2 billion.

Table 6.5.4 compares the net Exchequer cost of all pensions, including an increased State pension, with the projected cost of the current system.

Table 6.5.4 – comparison of net Exchequer costs, % of GNP

	2006	2016	2026	2036	2046	2056
Current	2.4%	3.9%	5.5%	5.9%	6.2%	7.0%
Increased SW	2.5%	5.6%	7.1%	7.3%	7.0%	7.1%

Note that Exchequer costs comprise a variety of costs including benefit payments, net contributions to the NPRF and notional cost of tax forgone, less additional tax income. An analysis of the composition of the cost is given in table 11 of Appendix E.

The effect on Exchequer costs of the increased State pension is at its greatest from 2016. At this point the full amount of the increased State pension is payable, but the amount accumulated in additional contributions is not yet significant. This is discussed further in section 6.7. The amount of the additional Exchequer cost in 2016, expressed in 2006 values, is about €2.3 billion.

The projections show very little additional Exchequer cost by 2056. This is a result of the pre-funding assumption discussed in section 6.9.

6.6 Any economic projections are uncertain, and increasingly so the longer the period of the projection. Whilst bearing this in mind, the Oversight Committee examined alternative projections which attempted to make allowance for the significant economic effects of this pension system. However, without further study, the basis for making such adjustments is not clear. For completeness, the results of the projections are summarised below and included in Appendix E, but the results in 6.5 should be seen as the primary projections of this project.

After consideration of the results of the ESRI models, it was decided to make adjustments to the assumed rates of growth in earnings and GNP and to the assumed numbers of those in employment. The approach adopted was as follows:

- The economic impacts after the first ten years were assumed to equal those modelled by ESRI assuming full impact after five years, and shown above in table 6.4.1. As this model assumes gradual introduction over 10 years, these effects were assumed to grow gradually over the introductory period.
- Because initial modelling showed clearly that the cost of an increased State pension would continue to grow over the period being modelled, it was assumed that the economic impact would continue to increase after the initial ten years. It was assumed that the adjustments after ten years would be doubled over the remaining 40 years.

The adjustments made to the projection bases are summarised in table 6.6.1:

Table 6.6.1 – assumed economic impact

First 10 years	GNP	99% in year 10
	Salary	95% in year 10
	Employment	97% in year 10
Following years	GNP	Reducing to 98% by year 50
	Salary	Reducing to 90% by year 50
	Employment	Reducing to 94% by year 50

The following table compares the projections in section 6.5 above with those on the adjusted basis,

Table 6.6.2 – effect of change in economic assumptions, % of GNP

	2006	**2016**	**2026**	**2036**	**2046**	**2056**
Projected benefits						
NPR basis	5.3%	8.4%	11.3%	14.4%	18.1%	19.9%
Adjusted basis	5.3%	8.5%	11.4%	14.5%	18.3%	20.2%
Projected contributions						
NPR basis	6.7%	8.6%	8.8%	8.7%	8.3%	8.3%
Adjusted basis	6.7%	8.3%	8.3%	8.2%	7.8%	7.7%
Projected Exchequer cost						
NPR basis	2.5%	5.6%	7.1%	7.3%	7.0%	7.1%
Adjusted basis	2.5%	5.5%	7.1%	7.2%	6.9%	7.1%

Coverage and adequacy

6.7 Table 4.2.1 above shows that in 2004, almost 30% of the working population earned less than twice the then State pension. We therefore assume that for this 30%, the State pension would therefore provide a retirement income of at least 50% of pre-retirement income. Were the State pension increased to 50% of GAIE, we estimate that the pension would then equal at least 50% of current earnings for at least 50% of the working population.

The remaining 50% of those working would need some supplementary provision in order to meet the NPPI replacement income target. Again, based on the 2004 data in table 4.2.1, we estimate that the actual figure would be 36%. Furthermore, it is possible that supplementary pension coverage rates among this group would fall as a result of additional contributions to fund the additional State pension.

6.8 The projections set out in the tables in section 6.5 above are on the central basis of projection as used in the NPR. Table 6.8.1 shows the effects of changing the projected rates of immigration.

Table 6.8.1 – change in migration, % of GNP

		2006	2016	2026	2036	2046	2056
Benefits	Lower	5.4%	8.9%	12.2%	15.8%	19.5%	21.1%
	Central	5.3%	8.4%	11.3%	14.4%	18.1%	19.9%
	High	5.2%	7.7%	9.9%	12.1%	14.8%	16.8%
Contributions	Lower	6.7%	8.5%	8.6%	8.6%	8.2%	8.2%
	Central	6.7%	8.6%	8.8%	8.7%	8.3%	8.3%
	High	6.7%	8.7%	8.8%	8.8%	8.5%	8.4%
Exchequer costs	Lower	2.6%	6.0%	7.8%	7.8%	7.5%	8.1%
	Central	2.5%	5.6%	7.1%	7.3%	7.0%	7.1%
	High	2.5%	5.1%	6.3%	6.1%	5.4%	5.2%

Funding

6.9 The modelling performed by Life Strategies assumed that specific additional contributions would be made in respect of the increase in State pension, and that these contributions would be invested, whether via an increased contribution to the NPRF or some similar mechanism. The fact of this modelling does not pre-empt any decisions about pre-funding, and it is relatively straightforward to estimate the effects of an unfunded increased pension from the detailed tables in Appendix E. However, even if the increase is not funded, the amount of the notional contributions that would be required is in itself valuable information about the long-term economic cost of the benefit.

The additional contribution was calculated to be the average contribution that each person at work would have to make throughout their working lifetime to provide sufficient funds to pay for the increased pension. This

contribution rate would be 9.2% of total income (i.e. not subject to any contribution ceiling) or about €4.8 billion per annum.

As the calculated contribution rate is a full working life rate, the contributions are not sufficient to pay for all of the increase for those who are already working, and there are obviously no contributions assumed in respect of those who have already retired. This element of the additional pension would have to be met through the budgetary process. Table 6.9.1 shows the unfunded additional pension paid each year, i.e. that for which no additional contributions have been made, as a percentage of GNP.

Table 6.9.1 – cost of unfunded increases, % of GNP

	2006	2016	2026	2036	2046	2056
Annual cost	0.1%	1.6%	1.7%	1.5%	1.1%	0.5%

The amount of unfunded obligations in 2016, expressed in 2006 values, is about €2.2 billion. These costs are included in the totals in table 6.5.4.

For modelling purposes only, the additional contributions were assumed to be split equally between employers and employees, i.e. a contribution of 4.6% of income each. This assumption is not intended to pre-empt any discussion of how this cost should be met. There is a wide variety of possible approaches, including the following:

(a) PRSI rates could be increased, with contributions being made by various combinations of employers, employees, the self-employed, and the Exchequer. This approach would be explicitly redistributive, in keeping with the current PRSI system: there would be no necessary link between the increase in individual contributions and the increase in benefits received. The cost of the current PRSI system is designed to be shared among employees, employers, self-employed and the Exchequer (to be recovered through taxation). If the increase in PRSI was not sufficient to meet the increased pension costs, the balance would have to be met through the Exchequer budgetary process.

(b) If it were decided that the increased pension costs were not meant to be redistributive, then the additional contributions would have to be related to the additional benefit. However, as the increase in benefit would be very similar for all PRSI contributors, irrespective of their income, it follows that the increased contribution would have to be similar for all contributors, irrespective of their income. This is unlikely to be acceptable.

(c) The contribution could be met through the Exchequer's budgetary process and recovered through taxation. This would be broadly

similar to the contributions made to the NPRF. The amount could be held in a fund similar to the NPRF, or in the NPRF itself (i.e. increase the payment from its current level of 1% of GNP each year).

Implementation issues

6.10 Many defined benefit pension schemes are integrated with the PRSI pension system, i.e. the benefits and usually the employee contributions are based on earnings less a deduction in respect of State pension. The effect of a significant increase in the amount of the State pension on those schemes would be to reduce the value and cost of the occupational scheme benefits payable, assuming that the total combined pension remains the same. This is to take account of the fact that the first "tranche" of a person's earnings are "pensioned" by the PRSI system. Thus, in integrated schemes, a person's total pension derives partly from their PRSI contributions and partly from their contributions to the occupational scheme. There are provisions in the Pensions Act, 1990 (as amended) which do not permit any reduction of pensions already in payment as a result of State pension increases. However, those members of integrated schemes who retired shortly after a State pension increase would see a reduction in the expected value of their scheme benefits, and this reduction would be proportionately greater for those on lower earnings. Were the State pension to increase by a considerable amount over a relatively short period, the question of extending some form of protection to members of the integrated occupational schemes who have not yet retired might arise.

Summary

6.11 Increasing retirement benefits by increasing the State pension is conceptually and administratively straightforward, and the cost depends on the amount of increase being considered. A summary of the most notable issues when considering this approach is as follows:

6.11.1 Any increase in the State pension will result in additional income for those who have already retired as well as for future pensioners. Redistribution will therefore occur between the current generation of workers and those who have already retired or who will retire shortly.

6.11.2 An increase in the State pension will not result in any additional administrative cost, as it will not cost the Department of Social and Family Affairs any more to administer the increased pension payments.

6.11.3 Unless the cost of the increase is fully met from additional contributions, the result of an increase will be that the Exchequer will be providing an additional benefit to all pensioners, irrespective

of whether they need it or not. This may be seen as a less efficient use of those resources compared to a more targeted approach and would give rise to significant opportunity costs in terms of overall public expenditure.

6.11.4 In order for a funded private-sector supplementary system to be successfully accepted, contributors must have trust in the financial system to provide a fair return for the contributions made. Equally, if people are obliged to make additional contributions in return for an increased State pension, they will want reassurance that the State will have the capacity to provide the return required for those retirement contributions to provide the promised level of the State pension. However, the State pension amount is set by the Government each year, and there are no long-term commitments about the level of benefit or any increase in the pension once paid, or even the age at which it will be paid or the qualification conditions. If additional contributions are to be charged, more definitive commitments may be thought necessary, which may have important implications in restricting budgetary flexibility going forward.

6.11.5 An increase in the level of State pension would result in a reduction in contributions and benefits from supplementary schemes which have a Social Welfare offset. There might also be a reduction in supplementary coverage resulting from the view that the higher State pension would provide adequate income.

6.11.6 Irrespective of how cost of the increased pension is met, the projected cost of providing the additional pension increases from 1.7% of GNP in 2016 to 4.8% of GNP in 2056, or, expressed in 2006 values, from about €2.3 billion to about €6.5 billion.

7. Supplementary model

Overview

7.1 This chapter examines a mandatory pension system which obliges qualifying earners to contribute to a funded supplementary system. Such systems are usually intended to provide contributors with retirement income above that provided by basic State provision. However, in some jurisdictions there may be no State provision, or such provision may be means-tested.

7.2 There is a wide variety possible in the specification of such a mandatory supplementary system. The most important parameters are

(a) Eligibility – who is obliged to contribute to this system

(b) Eligible income – for those eligible, what proportion of their earned income is subject to the system

(c) Benefit type – whether the benefits provided are defined benefit or defined contribution

(d) Contribution amount – the percentage of eligible income payable to the system to meet the cost (irrespective of whether, or how, it is shared)

However, as well as the above primary parameters, there are other issues to be considered, and these are discussed in sections 7.13 to 7.29 below.

Description

7.3 The supplementary model chosen for examination was as follows:

(a)	Eligibility	All employees and self employed (but see discussion of harmonisation in section 7.27 below).
(b)	Eligible income	All earned income between 200% and 600% of the State pension (between approximately €20,000 and €60,000 as at June 2006)
(c)	Benefit type	Defined contribution
(d)	Contribution rate	15% of eligible income

(e)	Exchequer contribution	5% (included in the 15% above). This would be in lieu of any employer and employee PRSI relief and of any employee tax relief on contributions
(f)	Pre-retirement access	None

Contributions would increase gradually from zero to the full amount in the ten years after introduction.

Voluntary pension provision would be allowed in addition to the mandatory contributions. However, a major issue is the extent that the introduction of mandatory supplementary pensions might be expected to impact on the existing level of voluntary supplementary provision.

7.4 The background to the chosen model was as follows:

7.4.1 One of the obvious eligibility questions is whether to limit inclusion to employees, or to include the self-employed. International experience shows that some jurisdictions limit mandatory schemes to employees, others include the self-employed. The rationale for leaving the self-employed out would be some may not be able to afford the contributions or that in many cases their business would provide for their retirement, and they therefore do not need the additional provision. However, it was decided to include them for a number of reasons:

(a) 16% of the Irish work-force is classed as self-employed, which is too large a proportion to exclude if the objectives of a mandatory system are to be met. Also there is considerable movement in Ireland between the categories of “employed” and “self-employed” and significant “blurring at the edges”, particularly in such sectors as building and construction and agriculture and fishing. In such sectors, income, rather than formal status, is a more appropriate determination of the need for a pension.

(b) The difference between being self-employed and being employed by one’s own company is not economically meaningful; again, income, rather than status, is the main determinant.

(c) There are many self-employed whose business will not have accumulated enough realisable capital value by the time they retire to provide an adequate retirement income, e.g. professionals working from home, tradespeople or craftspeople.

(d) If the self-employed were not included, this might act as an incentive to some employees or to their employers to inappropriately reclassify themselves as self-employed.

(e) The decision to include the self-employed in the PRSI system, for pensions, was on foot of the National Pension Board's recommendations in 1988 to ensure the maximum possible consistency and equity between social insurance pension arrangements for employees and self-employed people.

Another eligibility criterion might be age, or year of birth. A minimum age could be allowed for inclusion to exempt those who had just joined the workforce: the scheme might be gradually introduced by applying it only to those born in or after a designated year. The Board does not favour a minimum age for a number of reasons:

(i) Most people at young ages are likely to fall close to, or below, the minimum eligible income. The contributions by those who do not will enhance their likelihood of adequate retirement income.

(ii) The Board is of the view that implementation based on year of birth would be too slow. There is value in gradual implementation rather than immediate full contributions: however, if this process is too drawn out, the system would suffer all the drawbacks of implementation and regulation without any significant retirement provision benefits.

(iii) Were an employer contribution part of the design of a mandatory scheme, maximum or minimum ages could introduce distortions in the labour market.

7.4.2 The lower limit for eligible income was chosen by reference to the NPPI target of retirement income of 50% of pre-retirement income. Those earning less than twice the State pension will receive a retirement income of at least 50% if they are entitled to a full contributory pension. It can therefore be argued that it is not appropriate to include them in a mandatory supplementary system to provide them with additional retirement income, though they may choose to make voluntary additional provision, and it is important to facilitate this choice for the reasons set out below.

The progress of contributors' earnings throughout their working life will affect how adequate a pension they eventually have. Some people may have an income that increases in real terms through their working life; others may see their income reach a peak and then decline as they get older; others again may have an irregular income. If a contributor's income at retirement is lower in real terms than it typically

was during his or her working life, the retirement income will be high as a proportion of the earnings just before retirement. On the other hand, if earnings increase throughout the person's working life, the retirement income will be lower as a proportion of the earnings just before retirement, unless they start contributing even when their earnings are low.

7.4.3 The rationale for putting an upper income limit on eligible income is that there is less concern about replacing income at higher levels. Once income to a certain level has been replaced, it may be decided that replacing the remaining income should be left to voluntary provision.

There is no 'correct' value for an upper limit, and the definition of any upper limit raises the same issues of career averaging as for a lower limit. However, it is practical to specify the upper limit as a multiple of the lower limit, to maintain the real value of eligible income over time. If the upper limit is too close to the lower limit, the accumulated funds of contributors may be too low to justify the cost of the system. Based on the data in table 4.2.1, an upper limit of 600% of State pension, i.e. about €60,000 in 2006 values, is estimated to include all the earned income of 85% of taxpayers.

7.4.4 The most important element of the design of the scheme is whether it is defined benefit (DB), i.e. retirement benefits based on earnings, or defined contributions (DC), i.e. retirement benefits based on the accumulated value of contributions and accumulated investment returns. There are international examples of mandatory (or quasi-mandatory) schemes of both DB and DC.

A DB scheme removes much risk from the contributor – depending on the details of the scheme design, the contributor may not bear investment risk, salary inflation risk, longevity or interest rate risk. Under a DC scheme, all of these risks are usually borne by the contributors.

If the employer is to bear any of these risks, it follows that the employer contribution would have to be variable. If, for instance, the employer was to bear the investment risk, it would be necessary to increase employer contributions if investment returns were less than expected. The Board is not in favour of a variable employer contribution as a component of a mandatory scheme, and therefore any risks not borne by the employer must be borne by taxpayers through the Exchequer.

Were the Exchequer to underwrite the risks of a DB scheme, there would be a proportionately greater risk than is borne by the employer

in a company DB scheme: the employer almost always has the right to stop sponsoring the scheme and, in theory at least, refuse to meet any outstanding shortfall. This option would not be available to the State in a mandatory pension scheme.

Defined benefit schemes have also traditionally rewarded employees who spend most or all of their careers with the one employer. A mandatory system will need to be suitable for a mobile and atypical workforce as these are primarily the people who do not currently have pension provision. Defined contribution systems are better able to cater for such individuals. The individual nature of defined contribution systems can also be an important aspect of gaining acceptance from the participants. This is due to the fact that individual accounts are more tangible and often better understood by participants than accruing benefits.

Having considered the above issues, it was decided to examine a defined contribution scheme.

7.4.5 The contribution rate of 15% was chosen as a rate that, on typical assumptions, has a reasonable chance of providing a replacement income of at least 50% of average revalued pre-retirement income. A higher rate of contribution would obviously increase the likelihood of this 50% target being met. This topic is discussed further in section 7.5 below.

Under a defined contribution system, the retirement income of any individual contributor will depend on their contribution history and the rate of return earned during their membership of the scheme.

7.4.6 Any option to withdraw part of pension savings before retirement will reduce the adequacy of the retirement benefits, or require a compensating increase in the contribution rate to achieve the adequacy targets. As the usual reason for allowing pre-retirement withdrawals is to encourage participation, it was decided that this would not be appropriate for a mandatory system.

Contribution rate and benefit illustrations

7.5 The pension benefits received under a defined contribution system depend on a considerable number of factors, including:

(a) The benefit being provided, including any allowance for cost of living increases and spouse's benefits

(b) The contributions made for and by the participant

(c) How long the contributor will be a member of the scheme

(d) The investment returns – this in turn may depend on investment choices made

(e) Charges

(f) Investment guarantees, if any, and any associated charges

(g) Investment returns and life expectancy after retirement.

Many of these factors cannot be predicted in advance, and therefore the contribution needed to secure a given level of investment cannot be calculated precisely: an estimate must be made, based on assumptions about all of the above factors.

This supplementary scheme is intended to provide a benefit of 50% of average eligible income. It is assumed that the funds accumulated in the scheme will be used to provide a retirement income that increases each year broadly in line with expected inflation, but that has no allowance for a spouse's benefit. Note that this pension is not comparable to the State pension for a number of reasons:

(i) The State pension has increased at a rate equal to or above the increase in average earnings: however, there is no formal guarantee of any rate of increase.

(ii) The State pension provides spouse's benefits in retirement, but only if the spouse has no entitlement to a pension in his or her own right.

Depending on the assumptions made, the appropriate contribution rate could be somewhere between 12% and about 18%. A rate of 15% has been calculated on the basis of a reasonable set of assumptions, and this is the rate proposed for this system. It should be noted that it may be appropriate to increase the contribution rate over time to keep place with improving life expectancy. No such increase has been proposed under this system.

Were this system implemented, and decisions taken about the investment and administration issues described in sections 7.15 to 7.25 below, it would be appropriate to review the contribution rate in the light of these decisions.

7.6 Although the benefits of a defined contribution system cannot be predicted with certainty, it is useful to consider a number of illustrated outcomes to understand the system.

The projections in the tables below estimate the retirement income that will be received by contributors to this system. This table assumes that a contribution rate of 15% of eligible income throughout a working lifetime will result in additional retirement income of 50% of eligible income. It is

important to repeat that these projections are illustrations and not predictions, and are not the only reasonable basis on which projections could be made.

Table 7.6.1 compares the benefits projected for contributors with different levels of earnings, on the assumption that their earnings are a constant percentage of the State pension. For clarity, it is assumed that the value of the State pension is €10,000 p.a. and therefore that the lower and upper limits of eligible income are respectively €20,000 and €60,000.

Table 7.6.1 – projected benefits

Earnings (in 2006 values)	**€20,000**	**€50,000**	**€80,000**
Supplementary contributions (% of total earnings)	0.0%	9.0%	7.5%
Pension including State pension (replacement %)	€10,000 (50%)	€25,000 (50%)	€30,000 (37.5%)
Pension excluding State pension (replacement %)	€0 (0%)	€15,000 (30%)	€20,000 (25%)

Because the supplementary scheme is a defined contribution arrangement, there are many factors which may have an effect on the retirement income from the scheme. The tables below illustrate the effects of the most important.

Table 7.6.2 shows the effect on retirement income if the investment return is on average 0.5% higher or lower than assumed above.

Table 7.6.2 – change in investment return

Earnings (in 2006 values)	**€20,000**	**€50,000**	**€80,000**
Assumed investment return +½%			
Pension including State pension (replacement %)	€10,000 (50%)	€26,800 (54%)	€32,300 (40%)
Pension excluding State pension (replacement %)	€0 (0%)	€16,800 (34%)	€22,300 (28%)
Assumed investment return -½%			
Pension including State pension (replacement %)	€10,000 (50%)	€23,500 (47%)	€28,000 (35%)
Pension excluding State pension (replacement %)	€0 (0%)	€13,500 (27%)	€18,000 (23%)

Table 7.6.3 shows the effect on retirement income if the cost of buying a pension at retirement is 10% higher or lower.

Table 7.6.3 – change in pension cost

Earnings (in 2006 values)	€20,000	€50,000	€80,000
Assumed pension cost +10%			
Pension including State pension (replacement %)	€10,000 (50%)	€23,500 (47%)	€28,000 (35%)
Pension excluding State pension (replacement %)	€0 (0%)	€13,500 (27%)	€18,000 (23%)
Assumed pension cost -10%			
Pension including State pension (replacement %)	€10,000 (50%)	€26,500 (53%)	€32,000 (40%)
Pension excluding State pension (replacement %)	€0 (0%)	€16,500 (33%)	€22,000 (28%)

Economic aspects

7.7 As described in section 6.4, the ESRI were asked to assess the impact of this pension system using their HERMES economic model. Their full report is included as Appendix B.

Again, it must be remembered that the ESRI model is designed to project relatively small changes in economic circumstances over relatively short periods of time. It cannot be used to provide projections over the 50 years covered by the Life Strategies calculations. Furthermore, it is likely to be less reliable in assessing pension systems where total contributions differ considerably from the current system. Nonetheless, it is useful to consider the projected effects using the model.

Table 7.7.1 shows the projected effects of this pension system were it fully in place in five years, i.e. had the contributions reached their full amount. As can be seen from the table below although the economic impacts are not

as large as arise under the first option, there are significant effects on GDP, employment and earnings.

Table 7.7.1 – projected economic impact after 5 years

	% change
Real GDP	-1.4%
Real GNP	-0.3%
Employment	-1.2%
Unemployment Rate	+0.3%
Wages	-2.3%
Real Personal Disposable Income	-5.6%
Balance of Payments, % of GNP	+1.8%
Personal savings, % of disposable income	-1.0%

Costings

7.8 The tables below show the results of the projections of this system prepared by Life Strategies. Readers are reminded of the limitations of these projections, discussed in section 4.3. These projections are on the NPR central basis. Details of this basis as well as projections on alternative bases are provided in Appendices D and E.

Table 7.8.1 compares the total benefits provided under this system with those projected under the current pension system. The benefits shown include all the occupational retirement pension benefits paid in each year including contributory State pension and private and public sector supplementary provision. All results are expressed as a percentage of GNP.

Table 7.8.1 – comparison of benefits

	2006	**2016**	**2026**	**2036**	**2046**	**2056**
Current	5.2%	6.7%	9.1%	11.8%	15.0%	16.6%
Mandatory	5.2%	6.7%	9.2%	12.2%	16.1%	18.1%

The projection of the current pension system shows the total amount of benefits increasing in the future as the numbers of people in retirement

increase. The benefits shown under the mandatory system projection show a further increase in benefits as the accumulated funds gradually result in higher benefits, though it should be borne in mind that the modelling assumes that the mandatory pensions will result in some reduction in voluntary supplementary provision – full details are provided in Appendix D.

In 2006 values, the projected additional benefits in 2056 total about €2 billion.

Table 7.8.2 compares the total pensions contributions under the current system - that proportion of personal and employer PRSI contributions attributable to State retirement pensions plus all contributions to supplementary pensions - with all contributions under the mandatory system. This table shows these results as a percentage of GNP.

Table 7.8.2 – comparison of contributions, % of GNP

	2006	2016	2026	2036	2046	2056
Current	6.7%	7.0%	6.9%	6.8%	6.6%	6.6%
Mandatory	6.8%	8.0%	7.9%	7.6%	7.1%	7.1%

The total contributions under the current system show some increase as a result of a projected slight increase in the numbers in employment. This increase is gradually offset by the effect of the trend from defined benefit to defined contribution provision as existing defined benefit schemes are wound down and substituted by defined contribution schemes in line with the assumptions for this option.

The projections for the alternative system show the effect from 2016 of the additional mandatory supplementary.

It is also useful to express the contribution costs as a percentage of workforce earnings as follows:

Table 7.8.3 – comparison of contributions, % of earnings

	2006	2016	2026	2036	2046	2056
Current	15.5%	15.5%	15.7%	15.7%	15.4%	15.4%
Mandatory	15.6%	17.7%	17.9%	17.5%	16.5%	16.5%

The amount of the additional contribution in 2016, expressed in 2006 values, is about €1.3 billion p.a.

Table 7.8.4 compares the Exchequer cost of the mandatory system with the projected cost of the current system as a percentage of GNP.

Table 7.8.4 – comparison of Exchequer costs, % of GNP

	2006	2016	2026	2036	2046	2056
Current	2.4%	3.9%	5.5%	5.9%	6.2%	7.0%
Mandatory	2.5%	4.5%	6.2%	6.6%	6.8%	7.5%

Note that Exchequer costs comprise a variety of costs including benefit payments, net contributions to the NPRF and notional cost of tax forgone, less additional tax income. An analysis of the composition of the cost is given in table 26 of Appendix E.

The increased cost to the Exchequer is mainly the result of the Exchequer contribution to the mandatory scheme. The tax foregone on investment return increases over time, but this is partially offset by tax from increased pension benefits. Expressed in 2006 values, the additional Exchequer cost in 2016 is projected to be €0.8 billion.

7.9 As for the other systems, the Oversight Committee examined alternative projections which attempted to make allowance for the significant economic effects of this pension system. However, without further study, the basis for making such adjustments is not clear. For completeness, the results of the projections are summarised below and included in Appendix E, but the results in 7.8 should be seen as the primary projections of this project.

After consideration of the results of the ESRI models, adjustments were made to the assumed rates of growth in earnings and GNP and to the assumed numbers of those in employment. The approach adopted was as follows:

(a) The economic impacts after the first ten years were assumed to equal those modelled by the ESRI assuming full impact after five years and shown above in table 7.7.1. As this model assumes gradual introduction over 10 years, these effects were assumed to grow gradually over the introductory period.

(b) Unlike the modelled increase in the State pension, the impact of this system does not increase at the same rate. It was therefore decided to make no further adjustments to the projection basis after ten years.

The adjustments made to the projection bases are summarised in table 7.9.1:

Table 7.9.1 – assumed economic impact

First 10 years	GNP	99.7% in year 10
	Salary	97.7% in year 10
	Employment	98.8% in year 10
Following years	GNP	As for year 10
	Salary	As for year 10
	Employment	As for year 10

The following table compares the projections in section 7.8 with those on the adjusted basis,

Table 7.9.2 – effect of change in economic assumptions, % of GNP

	2006	2016	2026	2036	2046	2056
Projected benefits						
NPR basis	5.2%	6.7%	9.2%	12.2%	16.1%	18.1%
Adjusted basis	5.2%	6.7%	9.2%	12.1%	16.1%	18.1%
Projected contributions						
NPR basis	6.8%	8.0%	7.9%	7.6%	7.1%	7.1%
Adjusted basis	6.8%	7.8%	7.7%	7.4%	7.0%	6.9%
Projected Exchequer cost						
NPR basis	2.5%	4.5%	6.2%	6.6%	6.8%	7.5%
Adjusted basis	2.5%	4.4%	6.1%	6.5%	6.8%	7.3%

Coverage and adequacy

7.10 The comparison of coverage and adequacy under the current system and under this system is complex. Broadly speaking, this system will increase the number of people paying supplementary contributions (or having contributions paid on their behalf) and receiving benefits, but the average amount of these benefits will be smaller than the average benefit of those with pension provision under the current system.

The data in table 4.2.1 show that in 2004 about 70% were earning at least twice the amount of the contributory State pension. As the lower limit for

contributions for this system is twice the State pension, it can be estimated that the result will be that 70% will be making some contribution, howsoever small.

The average amount of benefits under this new system will be lower than under the current system. There are a number of different effects operating to produce this result:

(a) There is a large increase in the number of people making supplementary pension contributions. The average income of these new contributors is typically less than the income of those contributing under the current voluntary system.

(b) The supplementary benefit as a proportion of retirement earnings under the mandatory system is lower than the average benefit under the current system.

(c) There may be some reduction of existing voluntary contribution as a result of the introduction of the mandatory system.

7.11 The projections in section 7.8 above are on the central basis of projection as used in the NPR. It is useful to compare the effect of changes in some of the assumptions.

Table 7.11.1 shows the effects of different migration assumptions:

Table 7.11.1 – change in migration, % of GNP

		2006	2016	2026	2036	2046	2056
Benefits	Lower	5.3%	7.1%	9.9%	13.3%	17.3%	19.1%
	Central	5.2%	6.7%	9.2%	12.2%	16.1%	18.1%
	High	5.1%	6.1%	8.0%	10.2%	13.3%	15.4%
Contributions	Lower	6.7%	7.8%	7.7%	7.4%	6.9%	6.8%
	Central	6.8%	8.0%	7.9%	7.6%	7.1%	7.1%
	High	6.8%	8.0%	8.0%	7.8%	7.4%	7.4%
Exchequer costs	Lower	2.6%	4.8%	6.7%	6.9%	7.1%	8.2%
	Central	2.5%	4.5%	6.2%	6.6%	6.8%	7.5%
	High	2.5%	4.0%	5.5%	5.5%	5.5%	5.8%

Because the system being examined is a defined contribution system, the

rate of return assumed on investments is of considerable importance. Table 7.11.2 shows the effects of different investment return assumptions:

Table 7.11.2 – change in investment return, % of GNP

		2006	2016	2026	2036	2046	2056
Benefits	-0.5% p.a.	5.1%	6.6%	9.1%	11.9%	15.6%	17.5%
	Central	5.2%	6.7%	9.2%	12.2%	16.1%	18.1%
	+0.5% p.a.	5.2%	6.7%	9.3%	12.5%	16.7%	18.8%
Contributions	-0.5% p.a.	6.8%	8.0%	7.9%	7.6%	7.1%	7.1%
	Central	6.8%	8.0%	7.9%	7.6%	7.1%	7.1%
	+0.5% p.a.	6.8%	8.0%	7.9%	7.6%	7.1%	7.1%
Exchequer costs	-0.5% p.a.	2.5%	4.4%	6.0%	6.6%	7.1%	7.9%
	Central	2.5%	4.5%	6.2%	6.6%	6.8%	7.5%
	+0.5% p.a.	2.5%	4.6%	6.3%	6.5%	6.3%	6.9%

More detailed projection results are shown in Appendix E.

Lower contribution

7.12 In addition to the projections described in section 7.8, projections were prepared assuming a 9% rather than a 15% contribution rate. This lower rate would obviously result in less adequate benefits for participants. On the other hand, contribution and Exchequer costs would be correspondingly lower.

Table 7.12.1 compares the total projected benefits provided under this system with those projected under the current pension system, i.e. the total pensions paid, including State retirement benefits. These projections are done on the NPR central basis. All results are expressed as a percentage of GNP.

Table 7.12.1 – comparison of benefits

	2006	2016	2026	2036	2046	2056
Current	5.2%	6.7%	9.1%	11.8%	15.0%	16.6%
Mandatory 15%	5.2%	6.7%	9.2%	12.1%	16.1%	18.1%
Mandatory 9%	5.2%	6.7%	9.1%	12.0%	15.7%	17.4%

The above table shows that there are no significant additional benefits under either mandatory system for about 20 years. This reflects both the low accrued funds in those years (especially given that the full contribution rate is not reached until 2016) and the relatively small numbers retiring. After 2026, both mandatory systems result in gradually increasing benefits.

Table 7.12.2 compares the total pension contributions under the current system (including personal and employer PRSI contributions) with those under the mandatory system. This table shows these results as a percentage of GNP.

Table 7.12.2 – comparison of contributions, % of GNP

	2006	2016	2026	2036	2046	2056
Current	6.7%	7.0%	6.9%	6.8%	6.6%	6.6%
Mandatory 15%	6.8%	8.0%	7.9%	7.6%	7.1%	7.1%
Mandatory 9%	6.7%	7.4%	7.3%	6.9%	6.4%	6.4%

Note that the modelling assumes that in 2006 there are very low mandatory contributions made.

These contribution costs are shown in table 7.12.3 as a percentage of workforce earnings:

Table 7.12.3 – comparison of contributions, % of earnings

	2006	2016	2026	2036	2046	2056
Current	15.5%	15.5%	15.7%	15.7%	15.4%	15.4%
Mandatory 15%	15.6%	18.0%	18.1%	17.7%	16.7%	16.7%
Mandatory 9%	15.5%	16.5%	16.5%	16.1%	14.9%	14.9%

The total contributions under the 9% mandatory model are projected to be lower than under the current model in 2046 and after – this is a result of the assumed effect of the mandatory system on voluntary, particularly defined contribution provision. The actual effect would depend very significantly on the harmonisation provisions discussed in section 7.27 below.

Table 7.12.4 compares the Exchequer cost of the two mandatory systems with the projected cost of the current system.

Table 7.12.4 – comparison of Exchequer costs, % of GNP

	2006	2016	2026	2036	2046	2056
Current	2.4%	3.9%	5.5%	5.9%	6.2%	7.0%
Mandatory 15%	2.5%	4.5%	6.2%	6.6%	6.8%	7.5%
Mandatory 9%	2.4%	4.2%	5.8%	6.2%	6.4%	7.1%

The primary difference in the Exchequer costs shown is the assumed Exchequer contribution to the mandatory system.

Finally, table 7.12.5 compares projected benefits for the 15% and 9% alternatives.

Table 7.12.5 – projected benefits

Earnings (in 2006 values)	€20,000		€50,000		€80,000	
	9%	15%	9%	15%	9%	15%
Supplementary contributions (% of total earnings)	0.0%	0.0%	5.4%	9.0%	4.5%	7.5%
Pension including State pension (replacement %)	€10,000 (50%)	€10,000 (50%)	€19,000 (38%)	€25,000 (50%)	€18,000 (22.5%)	€30,000 (37.5%)
Pension excluding State pension (replacement %)	€0 (0%)	€0 (0%)	€9,000 (18%)	€15,000 (30%)	€12,000 15%	€20,000 25%

Detailed design aspects

7.13 The first and most important decisions about a mandatory system are those about the amount of contribution to be paid and who will be included in the system. These primary decisions must be taken before any other aspects are dealt with. However, once these initial decisions are taken, there remains an enormous amount of detailed work to be done. This aspect of a mandatory system must not be ignored, and there is considerable scope for differences of opinion about implementation matters.

The design of a mandatory supplementary pension system is extremely complex, involving many detailed decisions about aspects of the new pension arrangements and their interaction with existing pension provision. A number of these issues will need further discussion and development before a detailed implementation recommendation can be made. The most significant questions are set out in the following sections and the issues which must be considered are described.

(a) Division of contributions – pension contributions can be made by some or all of the following:

- the individual worker (whether employed or self-employed);
- his or her employer, where relevant
- the Exchequer – Exchequer contributions must then be recovered through the budgetary process (i.e. reduced public

expenditure in other areas or increased taxation or a possible increase in Government borrowing which must be serviced and repaid by future generations of taxpayers).

(b) Investment of contributions – there are a range of approaches to the investment of contributions, including the question of guarantees.

(c) Contribution collection and administration – membership of this system is likely to exceed 500,000, and it is clearly important that the collection and administration system be robust, reliable and low-cost.

(d) Harmonisation with existing provision – it is the strong view of the Board that any mandatory system should allow the continuation of existing adequate provision. However, it is recognised that the harmonisation of the new mandatory system with existing provision is probably the most complex aspect of the design and is likely to have significant effects on existing voluntary pension provision and other forms of discretionary savings.

Division of contributions

7.14 Once the appropriate level of total contribution has been settled, it is necessary to decide how payment should be shared. Contributions can be made by some or all of the scheme members; by their employers, where relevant; and by the Exchequer. Any contributions by the Exchequer must then be recovered through the budgetary system, i.e. from reductions in public expenditure in other areas, increased borrowing and/or from increased taxation. This could be through increased PRSI rates or a special levy, or some combination of these.

There is a wide range of views on an appropriate division of contributions. The following includes in no particular order the points and views noted in the preparation of this report,

(a) One view is that pensions are deferred pay and that employers have a responsibility to make pension contributions on behalf of their employees. Linked to this is the view that the cost of adequate retirement income is too great to be funded by employees alone. There is also a belief that if pension contributions were mandatory for all levels, this would prevent some employer gaining competitive advantage over others at the expense of employee future incomes.

(b) Another view is that mandatory employer pension contributions will endanger Ireland's international competitiveness and therefore should not be imposed. It is an aspect of this point of view that pension provision depends on economic growth and success, and that if this growth is endangered, it will not be practical to provide adequate pensions in any case. Of particular concern in this view is the effect of

mandatory pension contributions on the attractiveness of Ireland as an investment location.

(c) It has been suggested that part of the direct cost of a mandatory pension system should be met by Exchequer, even though this will have to be recovered elsewhere in the budgetary process, e.g. by increased taxation or borrowing. This Exchequer contribution could either be by means of tax relief, by a flat rate tax credit or a transparent direct contribution, as was done for SSIAs. This approach implies in the context of Ireland's obligations under the Stability and Growth Pact that support for pensions would be prioritised over other policy objectives in terms of public expenditure and taxation.

(d) One further view is that in the longer term, the division between employer and employee contributions will have the same economic effect, through the operation of supply and demand on labour and wages. In this view, although there may well be short-term distortions as the scheme is introduced, in the longer term, employers will reflect their pension costs in the wages they offer. Equally, mandatory employee contributions will also affect the labour market in regard to the wages they demand and the supply of labour.

(e) It has been suggested that a mandatory system could be introduced as part of a national wage agreement. Using this approach, agreements on pay increases would also include agreement on increased contributions to a mandatory system. This would allow the total contribution to be increased gradually, may avoid any reduction in real earnings, and might remove disagreement about whether contributions were employer or employee. However, as with all of these views, there is not agreement about this suggestion. Furthermore, not all employees are covered by national wage agreements.

A number of practical issues must be borne in mind when making any decision about the division of contributions

(i) If they are to have the same retirement income expectations, the self-employed will have to pay both employer and employee contributions. The alternatives would be for a higher Exchequer contribution for the self-employed than for those in employment, but this might give rise to significant distortions in the labour market.

(ii) There is support by some Board members for a flat-rate Exchequer support for mandatory pensions rather than tax relief. A flat-rate support would provide the same proportionate support to all contributors, whereas support through tax relief provides more benefit to higher rate tax-payers. However, if the structure of the Exchequer

support for a mandatory scheme differs from that for existing pension arrangements, anomalies would arise, and it is likely that some existing provision would be affected. In particular, were contributions to the mandatory system matched by an Exchequer contribution, they would appear to contributors to be more expensive than the same nominal contribution to an occupational pension scheme receiving tax relief. Thus for instance, a 5% contribution to an occupational scheme will cost the contributor less than 5% when the effect of tax relief is taken into account. On the other hand, if the Exchequer support is via an additional contribution to the pension, the cost to the contributor will be 5% regardless. Opportunities for arbitrage or simple misunderstanding between the alternatives must be avoided, and this may involve some reconsideration of the form of Exchequer support for existing pensions.

Investment

7.15 This section discusses the alternative approaches that could be taken to the investment of contributions. In any final decision, there are a number of issues which are likely to be taken into account:

(a) Those most likely to contribute to a mandatory system are those with no existing pension provision. These are therefore likely to be younger and less well-off than the average worker, and so may not have much experience or knowledge of investment.

(b) Where a mandatory system includes any investment choice, it must take account of the level of investment understanding among those faced with the choices. This should influence the choices offered and how they are communicated. There will also be a question of whether financial advice will be needed, and if so, how it will be financed.

(c) Ireland has a well-developed pension and investment sector, and existing expertise and structures should be used as far as possible.

(d) All of the mandatory systems considered by the Board provide that, as far as possible, existing arrangements be encouraged to continue, and that contributors to the mandatory system have the option of making additional provision above their mandatory contributions. The investment options under the mandatory scheme must not therefore make existing provision uncompetitive. However, the assumptions underlying the Board's analysis are that the introduction of a mandatory supplementary pension regime would have a significant impact on the future level of voluntary supplementary provision.

(e) The question of the role of the State, if any, in taking on investment risk on behalf of contributors must also be considered.

7.16 There are three fundamental approaches that could be adopted for the investment returns on a mandatory pension scheme:

X. The State could accept contributions, and declare an investment return each year, which would not necessarily directly reflect the return on the assets.

Y. The State could take responsibility for the investment of the contributions by outsourcing investment management to one or a number of investment managers (e.g. through the NTMA) but allocate the investment returns directly to savers.

Z. Investment could be wholly done by competing private sector providers.

In practice, the differences between these approaches might not be so clear-cut:

- Under Y, savers might be allowed to opt out to an investment manager of their choice. Y then becomes quite similar to Z.
- The State might provide some form of investment guarantee under Y. If the State chooses to charge for this guarantee by deducting some of the investment return in good years, this might result in an approach very similar to that described under X.

The approach described under X above would involve some redistribution from those whose contributions yielded higher investment returns to those who had lower returns. This redistribution is intended only to smooth investment returns. It is different to the redistribution undertaken in a first pillar system, whose purpose is to redistribute income from the better off to the less well-off. The mandatory pension system being described in this chapter is not intended to achieve any such redistributions.

7.17 A question that is frequently raised about mandatory pension schemes is, given the State is obliging contributors to invest, whether it should provide guarantees of investment return. If such investment guarantees are provided, a related question is whether they should be charged for.

There is no well known international example of a mandatory funded defined contribution arrangement (i.e. where the contributions are explicitly invested by the State or by the private sector) which provides investment guarantees, although the Chilean system guarantees a minimum income, which has a similar effect. Nonetheless, the view has been expressed that a guarantee, either of investment performance or minimum retirement income, must be provided in order to make a mandatory scheme acceptable.

The attraction of guarantees are clearly that they increase the acceptability of pension saving. They also reduce the volatility and unpredictability of retirement benefits and reduce variations among the retirement benefits of similar contributors. Guarantees do present challenges of cost and design. It can be difficult to calculate an appropriate long-term charge, and such a cost may in any case be higher than what the public would expect, particularly in times of good investment returns. The appropriate form of guarantee may also be problematic: the public might demand short term insurance against market fluctuations whereas arguably what they most need is a long-term floor to the value of their saving.

There are a number of possible approaches to providing investment guarantees. The most obvious are

(a) The Exchequer may guarantee minimum returns without charging, or for a fixed charge

(b) The Exchequer may provide a guarantee but seek to reinsure that guarantee in the market

(c) Private sector investment managers may be obliged to provide a specified guarantee to be allowed to participate in the pension system

(d) Private sector investment managers may be allowed to offer guarantees in a competitive market

Clearly there are potential drawbacks to any approach adopted.

If the State was willing to offer investment guarantees, it is unlikely that the State will be do so at no cost. Should the Exchequer provides a guarantee and charge explicitly for it (as distinct from an essentially arbitrary investment return allocation possible under approach X in 7.16) it would be difficult to arrive at a satisfactory price. In years of good investment returns, the Exchequer may come under pressure to reduce what would be seen as overcharging: in years of poor investment returns, the cost of the guarantee may be considerable and could exceed the total charges to date. The State would also have to decide whether to explicitly invest the risk charges, and if so, would have to identify the most suitable assets.

It would not make sense to provide a State guarantee without placing restrictions on contributors' investment choice, or even disallowing choice altogether. Without such limits, savers would be tempted to adopt high risk strategies and rely on the guarantee if funds underperformed, i.e. significant moral hazard would arise.

If the State was willing to provide investment guarantees, the State could consider reinsuring any guarantee it provided. However, the amount of

funds under guarantee might be a problem, and the price of the guarantee could fluctuate considerably over time.

If guarantees are to be offered competitively by investment managers, there would be a need to ensure that the terms of the guarantee are communicated and understood clearly by contributors.

7.18 In a mandatory system where the investment management is provided only by private sector managers, a prescribed maximum level of charges could be imposed. The rationale for such a limit could be that contributors may not be sufficiently aware of the charges imposed. An additional or alternative rationale might be that without a limit, competition between providers may not by itself reduce charges to what is seen to be a reasonable level. In the absence of a prescribed maximum, margins might be used for marketing rather than to reduce participant charges.

The appropriate level of these charges is difficult to agree – note the debate in the U.K. where a maximum charge of 0.3% per annum proposed by the Turner Commission was disputed by parts of the pension and investment management industries. The issue of maximum charges becomes more complicated if managers are allowed (or expected) to offer guarantees: the charge for such guarantees should be separated from the basic charges, but it may be difficult to prevent cross-subsidy.

The alternative is to allow the charges to be set competitively but to ensure that they are clearly communicated. Were this approach adopted, it would be worth considering limits to the forms in which charges could be made (as was done for PRSAs) to ensure that charges are directly comparable and can be easily understood.

7.19 Many if not most contributors to a mandatory system would have little or no knowledge of investment. It is therefore recommended that, if there is to be an investment choice offered, a default investment strategy must be provided, to a specification set out in regulation.

The difficulties and risks of a default strategy must nonetheless be recognised. Experience with PRSAs has shown how significant the detailed wording of the regulation is in determining the strategy. It is particularly important to avoid herd behaviour whereby all default strategies tend to cluster together rather than offering genuine choice. It is possible that a high proportion of investors would use a default investment strategy. It will be important that they realise that the default strategy is designed to be a reasonable and appropriate investment, but it is not risk free or the ‘best’ strategy available.

Implementation

7.20 In deciding on the most appropriate means of managing a mandatory system, the most important considerations are:

- keeping administrative costs low,
- devising a collection system that is simple and transparent to maximise compliance and contributor understanding, and
- minimising operational and set-up risks.

A number of different models for gathering contributions are considered below, including:

(a) the existing PRSI system,

(b) individual savings accounts held within a single national scheme,

(c) individual accounts held at one of a number of competing (non-profit) bodies,

(d) individual accounts held at a number of competing financial institutions.

There is clearly a connection between the collection and administration system and choice of the investment model described above. In particular, if it were decided not to use private sector investment, only the first of the above four options would be relevant.

Existing PRSI System

7.21 All employees and self-employed who earn more than the minimum income for the mandatory system are already included in the PRSI system, as are their employers. PRSI contributions are collected by the Revenue on an agency basis for the Department of Social and Family Affairs. It makes sense to consider whether the PRSI system could be used to collect mandatory supplementary contributions in addition to contributions already being collected for State pensions.

There are a number of potential advantages to collecting mandatory/quasi-mandatory pension contributions through the PRSI system including:

(a) minimisation of operational and set-up risks as a collection system with extensive coverage is already in place,

(b) the existing system is simple and transparent, with contributions clearly outlined in payslips, and is accepted by employers and employees,

(c) the administrative cost is likely to be low,

(d) payments are easily monitored through the existing arrangements, including annual P60 statements, facilitating monitoring of compliance levels,

(e) the system is likely to be more flexible than alternatives in dealing with variations in the number of contributors to the mandatory scheme.

The main disadvantages of using the existing PRSI system are:

(i) the potential complexities it would add to the current system and the operational risk in making the necessary changes,

(ii) the need for additional reporting functionality and speed,

(iii) uncertainties about whether the system could cope with multiple investment choices and optional contribution levels.

It is clear that considerable further investigation would be needed before deciding whether a modification of the PRSI system would be a practical option.

Individual savings accounts held within a single national scheme

7.22 An alternative to the PRSI system is to set up a national centralised system for collecting contributions.

It is proposed that the U.K.'s National Pensions Savings Scheme (NPSS) will collect contributions through a central collection agency. Individual accounts will be held within a single national scheme which will provide a range of different investment funds, purchase fund management services at a wholesale level and invest each individual's account in the different funds according to the individual's choice.

Neither individuals nor employers would choose between providers of administration services. All members hold their account in a single national scheme and the scheme would purchase outsourced operational services from competing service providers. The central system chooses between competitive providers of operational services who would bid for the contract to run the system.

Compared to collection by competing agencies or financial institutions, this approach offers potential advantages in terms of economies of scale, fee

minimisation etc. The potential drawbacks of this system include the limitation of consumer choice, the operational risks associated with developing a new clearing house system from scratch, the time delays implicit in setting up a new system and the start-up costs.

Competing administration providers

7.23 An alternative to a central collection agency and administrator would be to invite different administration providers to compete, possibly on a non-profit basis. Such agencies might for instance be set up by trade unions, employer groups or professional bodies. Employers or possibly contributors would choose to which of the different providers an individual was allocated, but regulation would ensure a minimum level of investment choice and contributor information from all providers.

This model can be seen as halfway between that of a central collection agency and the use of existing financial institutions. It seeks to avoid the operational risk of setting up one single collection agency and to use competition as a means of fostering service standards. It also seeks to benefit from economies of scale through a small number of providers managing relatively large numbers of contributors. Although this model is usually assumed to comprise non-profit providers, there does not seem to be any overriding reason to exclude for-profit operators, given regulation to ensure an acceptable level of service and perhaps price.

Financial institutions

7.24 A further alternative would be a system in which eligible participants would be enrolled into pension savings accounts held at different insurance companies, banks or other appropriate financial institutions. Rather than a central clearing house mechanism choosing the service provider, the individual (or possibly their employer) would make the necessary choices.

A specific proposal would be to require enrolment in a PRSA where an employee or self-employed has no alternative pension provision. Existing legislation requires employers to provide access to a Standard PRSA, including contribution deduction, for ‘excluded employees’ – broadly those employees with no or limited access to an occupational scheme. It would not be complex to turn this access obligation into a mandatory scheme.

The significant advantage of this approach is the lack of operational risk: systems and arrangements are already in place, and there is a well developed and competitive market in place. Potential drawbacks are:

(a) If the State is taking responsibility for investment, this model may not be practical,

(b) Individual and small group pension arrangements may not be cost effective for a mandatory scheme, particularly for small contributions,

(c) A larger number of potential providers may result in additional administration obligations and costs for employers,

(d) There would be significant challenges in monitoring compliance if there were a large number of financial institutions providing mandatory pensions.

Compliance and enforcement

7.25 Mandatory pensions would be unpopular with a large number of the people obliged to contribute. It will therefore be necessary to check that those eligible (and possibly their employers, depending on the scheme implemented) are making the correct contributions and that these are being passed on in good time to the appropriate place: the size of this regulatory challenge must not be minimised or underestimated.

Compliance can be fostered through supervision – checking on people, imposing penalties if they are not making or forwarding the necessary contributions – and/or incentives. An example of the latter approach is the Australian system where people are subject to a punitive tax charge unless they can demonstrate that they have made the required pension contribution.

The Board's experience of supervising the employer access provisions for PRSAs has been a low level of initial compliance and a considerable amount of work needed to increase this. Given that the PRSA access imposes no financial obligations and in many cases little or no administrative obligation, it must be expected that voluntary compliance with a mandatory supplementary system may not be universal.

Other aspects of the scheme that will affect the effort needed to secure compliance are

(a) The smaller the number of agencies or institutions collecting contributions, the simpler it will be to ensure compliance.

(b) The design of the rules governing harmonisation with existing pension arrangements will determine much of the complexity of the compliance effort. This will be particularly true for self-employed and personal pension provision, where contributions are often made once a year rather than as a regular percentage of income.

(c) Penalties for non-compliance should be civil rather than legal. It would not be practical or economic to prosecute every case of non-compliance.

No specific recommendations can be made on compliance and enforcement until many of the details of a mandatory system are settled. However, in making those decisions, the practicalities of supervision must be borne in mind and must be among the criteria on which the final decision is based. All of the models would require some authority to oversee the collection and allocation of contributions, and the administration and communication of entitlements.

Summary of administration issues

7.26 It is clear from the above that the detailed administrative and compliance issues of a mandatory system are extremely complex and that a great deal of further work is needed before any decisions can be made about these matters.

In designing a process for collection of mandatory or quasi-mandatory pension contributions, it is essential to ensure that:

(a) the system is transparent and easily understood, to maximise acceptability and compliance,

(b) costs are minimised for all stakeholders – employees, employers and the Exchequer: this is especially important as there may be relatively large numbers of small contributions,

(c) operational and implementation risks are minimised. As far as possible, existing structure and practices should be used, as far as this is economic and consistent with the design of the mandatory system chosen,

(d) sufficient account is taken of the compliance and supervision requirements and costs.

Harmonisation

7.27 It is the Board's view that the introduction of any mandatory pension system should have as little impact as possible on existing good pension provision. The priority for a mandatory system is to ensure that those individuals who are not currently making pension provision are required to do so, within the objectives of the system. Those who are currently making adequate provision should therefore have the facility to opt-out of the mandatory system. It is therefore an important part of the design of a mandatory system to define how the new requirements will be harmonised with this existing pension provision.

The objective of harmonisation is to ensure that a mandatory system interferes as little as possible with existing good pension provision. It may be the case that existing provision will decline (whether in coverage or

adequacy of provision) after the introduction of a mandatory system, particularly in relation to new entrants. This may happen as a result of behavioural change on the part of employers and/or potential contributors, however as much as possible it should not be as a result of any additional burden or disincentive introduced as a result of the mandatory system. All incentives need to be very carefully assessed to ensure that they do not adversely affect current provision.

Harmonisation provisions have the potential to be very complex, difficult to design and implement effectively and could comprise the greater part of the design and specification of a mandatory system. It is clearly not practical within the scope of this report to define these provisions in detail but set out below is an overview of the approach that might be taken.

Defined contribution schemes

Any employee who is a member of a scheme where the total contribution being paid by or on his or her behalf is at least equal to that which would be paid into a mandatory scheme would be exempted from the mandatory scheme. In most cases this should be relatively straightforward. However there are a number of issues that will need to be dealt with:

(a) The comparison of contributions will not always be straightforward. Contributions to an occupational scheme may be calculated on total earnings, on earnings less an allowance for State pension, and may or may not take account of fluctuating earnings such as overtime or bonuses. This is unlikely to be the same as the eligible contributions for the mandatory scheme. In practice, it will probably only be possible to determine at the end of a year whether or not the contributions to the mandatory scheme would have been higher.

(b) In making the contribution comparison, it may be necessary to factor in the effect of applying different types of tax relief, particularly if the mandatory scheme has a partially matching Exchequer contribution rather than tax relief.

(c) It must be considered whether the comparison should be based purely on the level of contributions or should also factor in the effect of charges. This will be particularly relevant where the occupational scheme is a condition of employment.

Defined benefit schemes

There is a perception that membership of any DB scheme is better than any other type of pension arrangement. However, this is not necessarily true as it depends on the nature of the benefits provided by the DB scheme and the level of contributions paid to the other arrangement. In order to establish whether an individual is better off in a DB scheme it would be necessary to

calculate the benefit entitlements under the scheme and compare these to the benefit entitlements under the mandatory scheme. However as both calculations would be based on unknown circumstances and would have to rely heavily on assumptions the comparison may be of limited value.

It may not be enough to use membership of any DB scheme to automatically exclude an individual from the mandatory system. There are some DB schemes that may provide benefits that are not as good as could be provided under the mandatory system. In particular there are some industry wide schemes that provide benefits based on notional salaries which could potentially result in relatively low replacement rates. It is therefore necessary to apply either a benefit test or a contribution test to a DB scheme in order to decide if membership justifies exemption from the mandatory scheme.

A contribution test would exempt membership from a scheme where contributions by or on behalf of a member at least equalled what would be paid to the mandatory scheme. Although this is a straightforward idea, there are considerable practical problems:

(i) By their nature, the contributions paid to a DB scheme fluctuate from year to year and this should be taken into account, possibly through an averaging mechanism. For example, an individual should not have to join a mandatory scheme because the DB scheme is in surplus and the employer is on a contribution holiday.

(ii) On the other hand, part of the contribution being paid may be to clear a deficit. It would not make sense to include such contributions in a contribution comparison.

(iii) There is no employer contribution to public service unfunded schemes: the costs to the State as employer arise when pensions are being paid, and not during the working lifetime of the public servants. However, it is clear that most if not all of these schemes are high quality and that a simple contributions test is not appropriate for them.

(iv) Contributions to a DB scheme are not allocated to any particular member, but are pooled to meet obligations as they arise. If an underfunded scheme is wound up, under the provisions of the Pensions Act, 1990, the first priority among member benefits is for pensioners in payment. The practical effect of this is that contributions by all members are first used for such pensioners. It is therefore difficult to make a direct comparison with a defined contribution scheme where each person's contributions are ring-fenced.

The alternative to a contribution test is a benefits test: if the actuarial value on a prescribed basis of the benefits of the scheme is greater than the

mandatory scheme, the scheme members are exempted from the mandatory scheme membership. This approach has a number of advantages over a contributions test. However, there are nonetheless some drawbacks and complexities:

1. A benefits test would be an additional compliance burden on DB schemes.

2. In some schemes, higher earners might pass the test, but those on lower earnings might not.

3. There is no obvious means of dealing with an underfunded scheme. Although the benefits may be more valuable than the mandatory scheme alternative, the fact that the scheme is underfunded clearly lessens to some, probably unquantifiable, extent the probability of receiving those benefits. It seems appropriate to make some adjustment – it would make no sense to place a high value on scheme benefits that are unlikely to be paid – but it would be unsatisfactory if the exemption status changed from year to year depending on the funding position of a scheme.

A benefits test is more satisfactory than a contributions test, but there are some aspects which would need to be considered further. It must be made clear that the eventual solution cannot be perfect in all cases except at the cost of disproportionate complexity, which would in itself be a significant disincentive to DB provision. The eventual solution must be pragmatic and sacrifice some measure of precision in favour of practicality.

One such pragmatic approach would be to provide an automatic exclusion to any member of a DB scheme. It would need to be made clear that there will be some anomalies created by adopting this approach. However it is the one least likely to provide any further disincentive to the continuation of such schemes.

Ultimately, the degree of complexity, including difficult legal and industrial relations issues, in harmonising and transitioning from existing pension provision to any mandatory system should not be underestimated in considering the practicality of the proposition.

PRSAs and Retirement Annuity Contracts

The issues with both PRSAs and Retirement Annuity Contracts (RACs or personal pensions) are largely the same as with defined contribution arrangements. However, there are some additional issues specific to these personal contracts:

A. It is common for individuals to have a number of such contracts, some of which may be regular contributions, and some of which may be

single or optional contributions. This obviously will make the mandatory test more complicated.

B. It is likely that the comparison must be done at the end of the tax-year.

C. It may be possible to perform a once-off adequacy check for members of an occupational scheme, and all that would be required thereafter would be confirmation of continuing membership. However, the test will have to be performed annually for those not members of such schemes.

D. It should be considered whether a comparison is made purely on a year-by-year basis or whether funds accumulated by an individual should be taken into account. For example, if a self-employed individual has been paying 20% of income into a personal pension for a number of years and then decided to pay nothing in one year, it might not be thought reasonable that they should have to make a contribution to the mandatory system. On the other hand, such a cumulative test may add considerable complexity.

7.28 Whatever harmonisation rules are adopted, the existence of a mandatory scheme may in any case indirectly affect other pension provision. Among the possible impacts may be:

(a) If a mandatory system provides a guarantee there may be pressure on private schemes to do so as well. Depending on the terms of the guarantee, this may not be possible or economic.

(b) An acceptable mandatory scheme is likely to have low charges, whether because of competition or direct regulation. This may put pressure on alternative pension provision.

(c) There will be an unavoidable compliance obligation on occupational schemes even if their members are exempted from the mandatory scheme. This might cause some marginal schemes to cease.

(d) If there are differences in the structure of Exchequer support between the mandatory scheme and other occupational and individual provision, contributors may attempt to arbitrage between them.

Pension benefits

7.29 The question of the form of pension benefits from a mandatory system is a practical issue which must be considered. Irrespective of the specific eligible income rules for a mandatory scheme, there will be a large number of small supplementary pension funds at retirement:

- It will take 40 years for a mandatory system to be mature, i.e. for those retiring to have been in the scheme for almost all of their working life. The retirement funds of those who retire before that time will be correspondingly smaller.

- Irrespective of where the minimum eligible income level is set, there will be those who are only slightly above it and who therefore are making only small contributions. Even after a full working lifetime of contributions, there will be those who have only accumulated relatively small funds because of the amount of their eligible income.

It may well not be practical to require people with small funds to buy annuities. Putting to one side the unpopularity of annuities, there are questions about whether it will be economic or even possible to buy annuities for relatively small amounts. There is also the obvious anomaly that those with personal pensions or PRSAs are allowed to invest in Approved Retirement Funds (ARFs) at retirement, and it would not help the acceptability of a mandatory scheme if contributors were always obliged to buy annuities at retirement.

The question of annuity purchase is wider than the question of mandatory pensions, and it is not within the scope of this report to make a recommendation. However, some possible solutions which could be explored are:

(a) Allowing those with accumulated funds of less than a certain amount to take their benefits as cash, though this might not be consistent with the goal of retirement income provision.

(b) Allowing contributors access to ARFs, though the emergence of large numbers from a mandatory scheme might increase the pressure to deal with the significant inconsistencies in the current ARF access rules. There would also be a need for financial advice to ensure that contributors understood the investment and longevity risks.

(c) Allowing those with funds of less than a certain amount to use their funds to increase their State pension entitlement, though there are differing views about this option.

Summary

7.30 It is clear from the preceding sections that the creation of a mandatory supplementary system is an extremely complex and challenging project. It is nonetheless useful to highlight the most important aspects that are likely to determine a decision about whether or not to opt for such a system:

7.30.1 A mandatory supplementary system as described in this chapter can be designed to achieve the NPPI coverage targets, and, within

the constraints of the model chosen, may achieve the NPPI income adequacy targets. However, such a model takes a full working lifetime to provide full benefits.

7.30.2 This model does not provide, and is not designed to provide, any additional benefits to those who have already retired, or who will retire shortly. If the present State pension is believed to be inadequate for this group, additional provision must be made.

7.30.3 A mandatory supplementary system will require significant new structures to be created, including:

- Contribution collection and supervision mechanisms
- Compliance monitoring
- Harmonisation structures for existing schemes.

It may be difficult to recover the costs of these structures from contributors. Furthermore, depending on the model chosen, they may involve some element of operational risk. It has to be decided whether the resulting eventual improvement in contributors' retirement justifies this effort.

7.30.4 If existing pension provision is to be protected and encouraged to continue, it is inevitable that relatively complex harmonisation rules will be needed. In any event the introduction of mandatory supplementary pension provision would be expected to have a significant impact on the current level of voluntary supplementary provision.

7.30.5 A fundamental decision is to what extent contributors will be exposed to market investment and its resulting volatility: most Board members believe that the alternative may be some form of State guarantee or State investment management.

8. Soft mandatory models

Overview

8.1 There is a great deal of support in Ireland and worldwide for soft mandatory or automatic enrolment pension systems. A soft mandatory system can be defined as a pension system where eligible workers are obliged to join, but they have the right to opt out and cease contributing if they wish.

The rationale for soft mandatory systems is the belief that many of those in work who do not have supplementary pension provision have not made a clear decision against such provision. Instead, in many cases, they have not got around to it, or always meant to do it shortly, or never completed the paperwork. It is believed that many of these people, if they were automatically enrolled in a pension arrangement and contributions were automatically deducted from pay, would not opt out of their pension scheme but would continue to make contributions.

It is planned to introduce compulsory soft mandatory savings schemes in New Zealand (the 'Kiwisaver') and in the U.K. (the NPSS). An outline of these proposals is provided in Appendix C.

This chapter considers a specific soft mandatory system, and looks at the issues raised both by this proposal and by such systems in general.

8.2 Many of the design and implementation decisions about a soft mandatory scheme are similar to those discussed in chapter 7 for a mandatory supplementary system, though with some significant differences. The design decisions are as follows:

(a) Eligibility – i.e. who is obliged to join the scheme and for what period before being allowed to opt out.

(b) Contribution rate – what initial rate of contribution would be required, and who would pay

(c) Exchequer contribution

(d) Opt-out conditions

(e) Pre-retirement access to funds

Description

8.3 The model chosen for consideration was as follows:

(a)	Eligibility	All those beginning employment on or after the date of introduction of the scheme who do not become members of occupational schemes immediately on beginning employment. There would be no obligation for those who are self-employed to join, but those who wished could. Those in employment at the date of introduction of the scheme would also have the option of joining.
(b)	Employee contribution	5% of income
(c)	Employer contribution	2% of income
(d)	Exchequer contribution	2% of income, to a maximum contribution of €750 p.a.
(e)	Opt-out	Contributors could cease contributions after three months' contributions had been made. No immediate refund of contributions would be allowed in the first year. Employer and Exchequer contributions could be returned to them rather than to the employee. All employees who would be eligible to join on beginning employment would be allowed to recommence contributions at any time on one month's notice
(f)	Access to funds	Contributors would be allowed to access 25% of their funds tax-free on one occasion before or at retirement.

8.4 The background to the chosen model was as follows:

8.4.1 The most suitable time to join a pension savings arrangement is at the beginning of employment, before spending habits have become established. This is also true to some extent on any change of employment.

Those who become members of occupational arrangements on beginning employment are obviously already making pension provision: the primary purpose of this system is to encourage those who have no other provision, and so those in occupational schemes would not be obliged to join, but would have the right to do so if they wished.

The idea of mandatory provision with opt-out cannot work for the self-employed as it would for employees. Those in employment will be included in the scheme and have ongoing deductions made from pay unless they take the necessary steps to opt out. However, a self-employed person must set up a pension savings arrangement for themselves in the first place, and it is not a passive savings arrangement. Furthermore, it would not be practical or economic to put in place the necessary resources to ensure self-employed compliance.

8.4.2 The appropriate employee contribution level for a soft mandatory scheme must seek a balance between a contribution that is enough to make a difference after allowing for costs, and a rate that is not so high that too many contributors will opt out at the earliest opportunity. The proposed 5% employee rate aims to achieve this balance. It must be emphasised that the total contribution rate proposed above will not of itself provide a retirement income close to the NPPI target of 50% of retirement income. There are some fears that this arrangement will become a de facto benchmark for all pension contributions, and that contributors will overestimate the retirement income it is likely to provide.

8.4.3 Existing pension saving receives Exchequer support through tax relief: a soft mandatory pension system will not succeed unless contributions receive some similar support. However, the proposed support is by means of a contribution match rather than via tax relief: this makes the support more visible, and more likely to be attractive to lower rate or non-taxpayers. The proposed Exchequer support is less valuable than the tax-relief available for higher rate taxpayers, and so is unlikely to persuade them to switch from existing pension arrangements.

8.4.4 The rationale for a minimum period of contribution is to discourage collusion about immediate opt-outs. There may be a small number of employers who would be unwilling to meet their obligations to allow employees to participate in the savings scheme and would, given the opportunity, put those employees under pressure to opt out immediately before any contributions are paid. A minimum contribution period would avoid this situation, and once the structures for deduction are in place in any case, employers will be less concerned about whether employees make ongoing contributions. While 3 months is suggested this period could be longer. A longer period is likely to decrease the number of individuals opting-out of the system.

If employees choose to opt out after making a small number of contributions, their accumulated savings will be small. They will make no practical difference to their retirement standard of living, and will be

uneconomic for the savings provider. There is also a risk that such small amounts would be forgotten and remain unclaimed. It therefore makes sense that small amounts could be refunded. However, a waiting period is being proposed for such refunds, so that the availability of a refund will not act as an incentive to opt out. Where employees do opt out they will only receive a refund of their own contributions. Employer and Exchequer contributions will be refunded to them and not to the employee. Were these contributions available to the employee it might in some cases act as an incentive to opt out and seek a refund.

As the purpose of this scheme is to encourage savings, employees who wish to rejoin after opting out (or who were not eligible for automatic inclusion) should be allowed to do so, subject to practical notification requirements.

8.4.5 It is proposed to allow contributors to access some of their funds before retirement as an incentive to save. Research seems to show that such a facility would increase the attraction of such a savings scheme.

Clearly any pre-retirement withdrawal will reduce the value of the retirement provision: the rationale of the limited withdrawal is to achieve a balance between encouraging contributions and trying to improve retirement provision.

Detailed design considerations

Employer contributions

8.5 The proposed U.K. savings scheme includes an employer contribution of 3% of earnings in addition to an employee contribution of 4% of earnings between a lower and upper limit. The proposed New Zealand scheme does not provide for any mandatory employer contribution. The question of employer contributions was discussed in 7.14 above, and the issues are similar for soft mandatory pensions. There are differing views among Board members about whether or not employer contributions should be required.

It is proposed that there is an employer contribution of 2% of earnings in order to encourage membership of the scheme. This also reflects the view that employers have some responsibility in retirement provision for their employees.

Employers would not be able to benefit from reduced PRSI contributions because of employees contributing to the scheme.

Investment

8.6 The range of options that could be considered for a soft mandatory scheme is theoretically just as wide as those considered in sections 7.15 to 7.19. However, it is more likely that investment choices will be limited to those currently available commercially:

(a) The numbers of participants in this system would be smaller than in a fully mandatory pension system. Furthermore, because this system is not mandatory except in respect of the initial contributions (which can in any case be refunded) arguments that the State has an obligation to provide or underwrite an investment guarantee are less compelling.

(b) Because of the smaller numbers, it would be more economic to use as far as possible the existing investment structures and products rather than create new structures.

(c) As a soft mandatory system involves an element of choice absent from a full mandatory system, it is even more important that it does not compete with existing provision, especially through the provision of guarantees or features not available commercially. On the other hand, there is no apparent reason why it should not provide price competition.

Savings versus retirement

8.7 Possibly the most significant difference between the proposed U.K. and New Zealand systems is that while the former is explicitly intended to supplement retirement provision, the New Zealand system is not specifically designed as such, but is instead a voluntary savings system, with restrictions and Exchequer incentives. In both jurisdictions, the background to the introduction of the proposed scheme must be taken into account: the U.K. scheme was proposed by the Turner Commission, whose terms of reference dealt specifically with retirement provision. In New Zealand, there are no incentives or Exchequer supports for retirement saving in excess of the first pillar State benefits.

An Irish soft mandatory system could therefore be specifically intended to increase pension provision, with corresponding incentives and restrictions, or could be used simply to encourage saving. Some of this saving would be available to contributors in their retirement.

A pension system would by its nature incorporate significant (though not necessarily total) restrictions on access to savings before retirement, whereas a savings scheme would probably have lesser restrictions. The issues that should be considered in this decision are:

- It is current policy since the end of SSIAs to provide Exchequer incentives for pension contributions, but not for other private savings.

The Exchequer contribution proposed above is therefore more consistent with a pension rather than a savings scheme.

- A savings scheme will be considerably more popular among potential contributors than a pension scheme. As a corollary, any Exchequer support is therefore likely to be more expensive.

Implementation

8.8 The implementation issues for a soft mandatory scheme are contribution collection and compliance supervision. These issues have been discussed fully in sections 7.20 to 7.25 above. Two points particular to a soft mandatory scheme are:

- The number of participants in a soft mandatory scheme as described here will be smaller than the mandatory scheme as discussed in chapter 7. The approach adopted for contribution collection is therefore more likely to be an adaptation of an existing system than a new creation.

- The biggest compliance problem is likely to be employers and employees colluding to avoid the scheme. Although the system has been designed to minimise the perceived barriers to entry, supervision of this problem will be challenging.

Existing pension provision

8.9 A soft mandatory system is much less likely to be disruptive of existing occupational pension arrangements compared to a mandatory supplementary scheme as in chapter 7. Because the proposed contribution rate is low, it is unlikely that many pre-existing schemes will provide lower benefits. The simpler contribution rates proposed also mean that there are unlikely to be anomalies within pension schemes between members about which is the more advantageous arrangement. There is therefore no need to have complex comparison rules: membership of an occupational pension scheme (i.e. excluding death benefit only schemes) would be sufficient to exempt an employee from the soft mandatory scheme.

Some people may be already contributing to existing PRSAs or RACs when they begin new employment, and may wish to continue these as an alternative to the soft mandatory scheme. However, there is no simple means of integrating a salary deduction soft mandatory system with discretionary contributions to an individual pension arrangement. The necessary compliance effort is unlikely to be justifiable. It is therefore proposed that employees contributing to personal pension arrangements would be obliged to join the savings system unless they were contributing an occupational or personal pension arrangement by payroll deduction.

Financial advice

8.10 Any soft mandatory scheme obliges the participants to make a decision at some point whether to continue contributions or to cease. This is not in every case a simple decision, and it cannot be said that it would always be in every participant's financial best interest to continue contributions.

An Exchequer contribution to the scheme makes it more likely that contributions are a good financial decision. However, because the proceeds of the scheme are likely to be fully or partially taxed, it cannot be assumed that contributions to this scheme are better than other, after tax, savings. If the expected tax rate on the scheme benefits is higher than the value of the Exchequer contribution support, there may be better savings alternatives. The issues of access to savings, risk tolerance and outstanding debts should be considered in any complete analysis of the decision to contribute. For example, it can often make better financial sense to pay off credit card debts rather than save money.

An employer contribution makes participation more advantageous and the decision more straightforward.

Another issue about which contributors might want or need financial advice is in the exercise of any investment choice. However, this need can be overcome if an appropriate default investment strategy is provided for participants.

Participants in this scheme may not have access to appropriate personalised financial advice. Employers would be neither willing to, capable of nor authorised to provide this advice. Ideally, savers should take independent financial advice from someone authorised to discuss the full range of financial alternatives available to them. However, this advice may not be available at a price that savers are able or willing to pay. There is, however, some international experience of useful generic advice being provided.

Administration of the system

8.11 One of the key issues in designing a soft-mandatory system is the question of how and who administers the system. There are broadly two options:

(a) create a new body which will arrange a number of fund providers which participants can chose from (as is proposed with the NPSS in the UK), or

(b) allow participants to choose from products approved by the regulator which meet specified criteria (as is proposed with the Kiwisaver in New Zealand)

The main advantage of creating a body to arrange funds is that the body would have strong purchasing power and be better positioned to get value on issues such as charges than individual participants. The body could also arrange for the provision of generic information and at least ensure consistency of information and service to participants.

One of the potential drawbacks of such a body is that it could take considerable time to put the appropriate structures and systems in place. It is not expected that the NPSS would be launched before 2010.

The main advantage of using products approved by the regulator which meet specified criteria is that this can build on existing structures within the financial services industry. This can ensure a much quicker lead in time. It would, for example, be relatively straightforward to use a variation of the Standard PRSA product for this purpose.

However a potential drawback is that participants may have more trust in a State operated system than products offered by the financial services industry. There would also be a lack of consistency of both service and performance which would make choosing the right provider a crucial decision.

Take-up and costs

8.12 The costs of a soft mandatory system depend on the take-up. The experience of SSIAs showed the difficulty of predicting take-up of what was a considerably simpler concept than a soft mandatory pension system, and there is no means of knowing how reliable any given estimate would be. The following comments may be of use:

- There are approximately 900,000 people at work (including self-employed) with no supplementary pension. The take-up among this group depends on how often they change employment (and are therefore included in the scheme), how willing or able they are to continue contributing once they are in a position to opt out.

- Of the 900,000 without supplementary provision, approximately 180,000 are self-employed. (Of course, some people change from self-employed to employed and vice versa from time to time). Of the remainder, one possible guess is that after five years 100,000 people would be making contributions to the scheme. Based on CSO earnings data, a typical employee contribution might amount to €1,500 per annum, with an additional €600 p.a. contribution each by the employer and Exchequer. The total cost to the Exchequer and employers in this scenario would therefore be €120 million per annum. However, this should be understood as more of an illustration than an estimate. As a comparison, the cost to the Exchequer of the SSIA

contribution match was about €433 million in 2002, €532 million in 2003 and an estimated €540 million in 2004.

Summary

8.13 The decision between a hard and soft mandatory system will not depend on these details but on the objectives identified.

The most notable issues to be considered about soft mandatory systems are:

8.13.1 A soft mandatory system leaves more choice to the individual contributor. As a result it is inherently more flexible than a fully mandatory system.

8.13.2 It is extremely difficult to predict the effect of a soft mandatory system on supplementary coverage. Although the U.K. and New Zealand plan to introduce such systems, there is no example of such a national system in operation. The success of such a system will depend on how effective is the promotion of such a system and how much it captures the interest of potential savers.

8.13.3 As for other mandatory systems discussed in chapter 7, a great deal of further work is needed to decide the design and implementation details.

9. Hybrid model

Overview

9.1 Any comparison of State and supplementary mandatory systems as a means of improving retirement provision will tend to emphasise the considerable differences between these approaches. It was therefore decided to examine a proposal that would incorporate elements of both systems to see whether a combined approach offered advantages or disadvantages compared to one or other alternative.

Description

9.2 The hybrid system considered in this chapter comprises an increase State pension as well as a mandatory supplementary system.

The proposed increase in the State pension is a 20% increase over the current level. This would increase the pension from the current level of 33% of GAIE to 40%, and in current values, would increase the weekly pension from €193 to €232.

In addition to the increased State pension, a mandatory supplementary system would operate as follows:

(a)	Eligibility	All employees and self employed
(b)	Eligible income	All earned income between 125% and 500% of the increased State pension (between approximately €15,000 and €60,000 as at June 2006)
(c)	Benefit type	Defined contribution
(d)	Contribution rate	15% of eligible income
(e)	Exchequer contribution	5% (included in the 15% above). This would be in lieu of any employer and employee PRSI relief and of any employee tax relief on contributions
(f)	Pre-retirement access	None

It is assumed in the costings that the pension is increased from its current level to the target level over a period of ten years, and its level is maintained as a proportion of average earnings thereafter. It is also assumed that

anyone receiving a contributory State pension will be entitled to the increased amount, irrespective of when they retired.

Contributions to the mandatory supplementary system are assumed to increase from zero to the full amount over ten years. Voluntary pension provision would be allowed in addition to the mandatory contributions.

9.3 The background to the chosen model was as follows:

9.3.1 The current level of contributory State pension is intended to avoid absolute poverty. However, many are of the view that the minimum occupational retirement income should be higher than this basic amount, although there is no consensus about the financing of a higher State pension.

9.3.2 There are practical obstacles to securing an adequate retirement income wholly through a first pillar pension. The hybrid system therefore includes a mandatory supplementary pension to which most people, including many earning less than 50% of the revised State pension, will contribute.

9.3.3 The eligibility criteria for the mandatory element are identical to those described in chapter 7, and the reasoning underlying this is as described in 7.4.1.

9.3.4 The lower limit for eligible income is intended to achieve a balance between the view that the State pension, even as increased, is unlikely to be seen as adequate by many people, and the difficulty of making contributions from low incomes. The chosen limit is approximately 50% of GAIE and approximately equal to the employee threshold for PRSI contributions. The upper earnings limit is the same as used for the model in chapter 7, for the same reasons.

9.3.5 The reasoning for opting for a defined contribution system is as described in 7.4.4.

9.3.6 The proposed contribution rate is intended to provide most participants with a retirement income which is a meaningful amount above the (enhanced) State pension and provide a reasonable standard of living in retirement.

9.3.7 As described in chapter 7 above, the view was taken that it was not appropriate to allow contributors pre-retirement access to their funds within a mandatory system.

Benefit illustrations

9.4 This proposal comprises a defined contribution element in addition to the State pension. The total benefits of contributors cannot therefore be predicted. However, as before, it is useful to consider a number of illustrated outcomes to understand the system.

The projections in the tables below estimate the retirement income that will be received by contributors to this system. This table assumes that a contribution rate of 15% of eligible income throughout a working lifetime will result in additional retirement income of 50% of eligible income. It is important to remind readers that these projections are illustrations and not predictions, and are not the only reasonable basis on which projections could be made.

Table 9.4.1 compares the benefits projected for contributors with different levels of earnings, on the assumption that their earnings are a constant percentage of the State pension. For clarity, it is assumed that the current value of the State pension is €10,000 p.a. and therefore the revised value would be €12,000 per annum.

Table 9.4.1 – projected benefits

Earnings (in 2006 values)	**€20,000**	**€50,000**	**€80,000**
Supplementary contributions (% of total earnings)	3.8%	10.5%	8.4%
Pension including State pension (replacement %)	€14,500 (72.5%)	€29,500 (59.0%)	€34,500 (43.1%)
Pension excluding State pension (replacement %)	€2,500 (12.5%)	€17,500 (35.0%)	€22,500 (28.1%)

Because the supplementary scheme is a defined contribution arrangement, there are many factors which may have an effect on the retirement income from the scheme. The tables below illustrate the effects of the most important.

Table 9.4.2 shows the effect on retirement income if the investment return is on average 0.5% higher or lower than assumed above.

Table 9.4.2 – change in investment return

Earnings (in 2006 values)	**€20,000**	**€50,000**	**€80,000**
Assumed investment return +½%			
Pension including State pension (replacement %)	€14,800 (74%)	€31,500 (63%)	€37,100 (46%)
Pension excluding State pension (replacement %)	€2,800 (14%)	€19,500 (39%)	€25,100 (31%)
Assumed investment return -½%			
Pension including State pension (replacement %)	€14,200 (71%)	€27,700 (55%)	€32,200 (40%)
Pension excluding State pension (replacement %)	€2,200 (11%)	€15,700 (31%)	€20,200 (25%)

Table 9.4.3 shows the effect on retirement income if the cost of buying a pension at retirement is 10% higher or lower.

Table 9.4.3 – change in pension cost

Earnings (in 2006 values)	€20,000	€50,000	€80,000
Assumed pension cost +10%			
Pension including State pension (replacement %)	€14,300 (71%)	€27,800 (56%)	€32,200 (40%)
Pension excluding State pension (replacement %)	€2,300 (11%)	€15,800 (32%)	€20,200 (25%)
Assumed pension cost -10%			
Pension including State pension (replacement %)	€14,800 (74%)	€31,300 (63%)	€36,800 (46%)
Pension excluding State pension (replacement %)	€2,800 (14%)	€19,300 (39%)	€24,800 (31%)

Coverage and adequacy

9.5 The increased State pension under this system will have the effect of increasing the minimum occupational income comfortably above the NPPI minimum target of 34% of GAIE – the costs of this increase are discussed in section 9.6 below.

The minimum eligible income under this system is €15,000, or 125% of the increased State pension. The result of this relatively low threshold is that everyone earning less than the upper earnings limit is projected to have a retirement income of more than 50% of pre-retirement income, i.e. more than the NPPI target of 50%.

Based on the data in 4.2.1, it is estimated that a lower limit of 125% of the State pension would result in about 80% of the working population making supplementary contributions. This would result in a coverage increase of about 30 percentage points from current levels.

Costings

9.6 The tables below show the results of the projections of this system prepared by Life Strategies. Readers are reminded of the limitations of these projections, discussed in section 4.3 above. These projections are on the NPR central basis. Details of this basis as well as projections on alternative bases are provided in Appendices D and E.

Table 9.6.1 compares the total benefits provided under this system with those projected under the current pension system, i.e. the total pensions paid, including State retirement benefits. All results are expressed as a percentage of GNP.

Table 9.6.1 – comparison of benefits

	2006	2016	2026	2036	2046	2056
Current	5.2%	6.7%	9.1%	11.8%	15.0%	16.6%
Hybrid system	5.2%	7.3%	10.0%	13.2%	17.3%	19.4%

The increases in the projected benefits in the current system are a result of the increased numbers in retirement. Under the hybrid system, the benefits increase further in 2016 almost entirely as a result of the higher State pension. The gradual effect of the mandatory supplementary contribution further increases benefits over time. In 2006 values, the increase in benefits in 2016 is about €1.0 billion, increasing to a projected €3.8 billion by 2056.

Table 9.6.2 compares the total pension contributions under the current system (including personal and employer PRSI contributions) with those under this hybrid system. Note that this includes the additional contributions in respect of the increase in the State pension. The table shows these results as a percentage of GNP.

Table 9.6.2 – comparison of contributions, % of GNP

	2006	2016	2026	2036	2046	2056
Current	6.7%	7.0%	6.9%	6.8%	6.6%	6.6%
Hybrid system	6.8%	8.9%	8.8%	8.5%	8.1%	8.0%

It is also useful to express the contribution costs as a percentage of workforce earnings as follows:

Table 9.6.3 – comparison of contributions, % of earnings

	2006	2016	2026	2036	2046	2056
Current	15.5%	15.5%	15.7%	15.7%	15.4%	15.4%
Hybrid system	15.7%	19.7%	19.8%	19.7%	18.7%	18.7%

The projections for 2016 show a significant increase in total contributions, compared to the current system, amounting to about €2.6 billion in 2006 values. This difference is projected to reduce thereafter, as a result of the assumed effect on voluntary provision of the increase in the State pension and the mandatory supplementary system.

Table 9.6.4 compares the Exchequer cost of the mandatory system with the projected cost of the current system.

Table 9.6.4 – comparison of Exchequer costs, % of GNP

	2006	2016	2026	2036	2046	2056
Current	2.4%	3.9%	5.5%	5.9%	6.2%	7.0%
Hybrid system	2.6%	5.3%	7.0%	7.3%	7.3%	7.8%

The Exchequer cost is considerably higher in 2016 as a result of the contributions to the supplementary system as well as the unfunded portion of the additional State pension. The unfunded costs diminish over time, reducing the projected difference between this system and the current system. In 2006 values, the additional Exchequer cost in 2016 is about €1.9 billion,

An analysis of the composition of the Exchequer cost is given in table 61 of Appendix E.

9.7 The projections in section 9.6 above are on the central basis of projection. As before, it is useful to compare the effect of changes in some of the assumptions.

Table 9.7.1 shows the effects of different migration assumptions:

Table 9.7.1 – change in migration, % of GNP

		2006	2016	2026	2036	2046	2056
Benefits	Lower	5.3%	7.8%	10.9%	14.5%	18.5%	20.5%
	Central	5.2%	7.3%	10.0%	13.2%	17.3%	19.4%
	High	5.1%	6.7%	8.8%	11.0%	14.2%	16.5%
Contributions	Lower	6.8%	8.7%	8.6%	8.3%	7.9%	7.8%
	Central	6.8%	8.9%	8.8%	8.5%	8.1%	8.0%
	High	6.9%	8.9%	8.9%	8.7%	8.4%	8.3%
Exchequer costs	Lower	2.7%	5.7%	7.6%	7.9%	8.0%	8.6%
	Central	2.6%	5.3%	7.0%	7.3%	7.3%	7.8%
	High	2.6%	4.9%	6.3%	6.3%	6.0%	6.2%

Because the mandatory supplementary element of the system is defined contribution, the rate of return assumed on investments is of considerable importance. Table 9.7.2 shows the effects of different investment return assumptions:

Table 9.7.2 – change in investment return, % of GNP

		2006	2016	2026	2036	2046	2056
Benefits	-0.5% p.a.	5.2%	7.3%	9.9%	12.9%	16.8%	18.9%
	Central	5.2%	7.3%	10.0%	13.2%	17.3%	19.4%
	+0.5% p.a.	5.2%	7.4%	10.2%	13.5%	7.8%	20.0%
Contributions	-0.5% p.a.	6.8%	8.9%	8.8%	8.5%	8.1%	8.0%
	Central	6.8%	8.9%	8.8%	8.5%	8.1%	8.0%
	+0.5% p.a.	6.8%	8.9%	8.8%	8.5%	8.1%	8.0%
Exchequer costs	-0.5% p.a.	2.6%	5.3%	6.9%	7.5%	7.6%	8.2%
	Central	2.6%	5.3%	7.0%	7.3%	7.3%	7.8%
	+0.5% p.a.	2.6%	5.4%	7.1%	7.2%	6.9%	7.2%

More detailed projection results are shown in Appendix E.

9.8 As for the other systems, the Oversight Committee examined alternative projections which attempted to make allowance for the significant economic effects of this pension system. However, without further study, the basis for making such adjustments is not clear. For completeness, the results of the projections are summarised below and included in Appendix E, but the results in 9.7 should be seen as the primary projections of this project.

The ESRI were not asked to model this pension system, but having considered the results of the ESRI projections for the other systems, it was decided to use the same assumptions as used in the projections for the increased first pillar pension described in chapter 6. These adjustments to the projection bases are as follows:

Table 9.8.1 – assumed economic impact

First 10 years	GNP	99% in year 10
	Salary	95% in year 10
	Employment	97% in year 10
Following years	GNP	Reducing to 98% by year 50
	Salary	Reducing to 90% by year 50
	Employment	Reducing to 94% by year 50

The following table compares the projections in section 9.6 with those on the adjusted basis,

Table 9.8.2 – effect of change in economic assumptions, % of GNP

	2006	**2016**	**2026**	**2036**	**2046**	**2056**
Projected benefits						
NPR basis	5.2%	7.3%	10.0%	13.2%	17.3%	19.4%
Adjusted basis	5.2%	7.4%	10.1%	13.3%	17.3%	19.4%
Projected contributions						
NPR basis	6.8%	8.9%	8.8%	8.5%	8.1%	8.0%
Adjusted basis	6.8%	8.4%	8.2%	7.9%	7.4%	7.3%
Projected Exchequer cost						
NPR basis	2.6%	5.3%	7.0%	7.3%	7.3%	7.8%
Adjusted basis	2.6%	5.2%	6.8%	7.2%	7.1%	7.7%

Funding

9.9 As for the system described in chapter 6, the modelling of this system assumes that specific additional contributions will be made to provide for the increases in the State pension, with these contributions split equally between employees and employers for the purpose of calculation.

As before, the contribution was calculated to be the average contribution that each person at work would have to make throughout their working lifetime to provide sufficient funds to pay for the increased pension. This

contribution rate would be 3.5% of total income, i.e. not subject to any contribution ceiling, or about €1.7 billion per annum.

This contribution is the estimated cost of providing the additional State pension over a working lifetime. However, the additional pension for those who have already retired or who are already in the workforce will not be fully funded from this contribution. The cost of this unfunded benefit, as a percentage of GNP, is given in table 9.9.1:

Table 9.9.1 – cost of unfunded first pillar increases, % of GNP

	2006	2016	2026	2036	2046	2056
Annual cost	0.1%	0.6%	0.6%	0.6%	0.4%	0.2%

As in chapter 6, the modelling assumed that the additional costs would split equally between employees and employers for the purposes of the projections. Readers are referred to the discussion in section 6.8.

Design and implementation

9.10 Sections 7.13 to 7.29 above explored a large number of issues that must be considered in the implementation of a mandatory supplementary system. As the mandatory supplementary contributions under this system are greater than under that described in chapter 7, these issues are of more importance under this system.

Summary

9.11 This hybrid model, part increased State pension, part supplementary system, was considered to see if it could overcome some of the drawbacks of other, single approaches. A summary of the most notable issues for consideration is:

9.11.1 This approach provides additional income for all occupational pensioners, including those who have already retired or who will retire shortly.

9.11.2 The eligibility limits as modelled are designed to provide an income in excess of the NPPI targets for everyone earning less than the upper earnings limit.

9.11.3 This system provides better retirement income than for the simple mandatory system considered in chapter 7, because of the additional State pension and the lower eligibility limits. The corollary is obviously higher contribution rates: the contributions for this system are very similar to those for the system in chapter 6.

10. Conclusion and recommendation

Recommendation

10.1 This report recommends that the most appropriate and practical approach to improving the position of pensioners in Ireland would be a combination of an increase in the State pension with a mandatory supplementary system for those at work who are not making supplementary provision. The system would be known as the Special Savings for Retirement and individuals would hold Special Savings for Retirement Accounts or SSRAs.

This recommendation is being made in response to the specific request of the Minister for Social and Family Affairs in his letter to the Board of 6 February 2006. It is not a recommendation for or against the introduction of such a system. Furthermore, the collective recommendation was made notwithstanding that Board members may individually have other preferences.

The Board member nominated by the Minister for Finance believes that owing to such factors disclosed in the report as the significant Exchequer costs, the broader macroeconomic effects and the prospective adverse impact on existing voluntary provision, the Board's recommendation does not comprise a workable option.

Detailed specification

10.2 The report recommends that the contributory State pension be increased to 40% of GAIE over ten years until 2016 or similar period, and that the real value of the pension be maintained at least at that proportion of GAIE thereafter.

10.3 In addition, it is recommended that a supplementary system called Special Savings for Retirement be set up for all employees who are not members of occupational schemes or do not have sufficient supplementary savings.

The detailed provisions of the scheme are similar to those described in chapter 9 and are as follows:

(a)	Eligibility	All employees and self employed who are not members of an approved pension arrangement or do not have sufficient supplementary savings would be automatically enrolled to the Special Savings for Retirement scheme (see 10.9(b) below)

(b)	Eligible income	All earned income between 50% and 200% of GAIE (between approximately €15,000 and €60,000). See 10.9(d) below
(c)	Total contribution rate	15% of eligible income. The split among employee/employer/Exchequer to be agreed as part of partnership.
(d)	Benefit type	Defined contribution (but subject to a minimum – see 10.9(f) below)
(e)	Access to funds	There would be no pre-retirement access to funds except in specified exceptional circumstances.

The mandatory contributions to the SSR would be introduced gradually over 10 years.

Recommendation background

10.4 None of the pension systems examined in the preparation of this report was unambiguously superior to any of the alternatives. The advantages and drawbacks of each of the alternative approaches are set out in chapters 6 to 9 of this report.

The primary reasons why the above system is being proposed are as follows:

(a) There is considerable support amongst the Board for an increase in the State pension as a means of improving retirement incomes for all existing and future retirees. However, the projections prepared for the Board make clear the high and growing cost of any significant improvement. The increase proposed above is intended to balance the considerations of improved retirement income and sustainability. The Board notes that an increase in the State pension as suggested would be of especial benefit to the lower paid.

(b) Because the proposed improvement in the State pension would be felt by many to be an inadequate retirement income, additional provision would be made through obligatory contributions to a supplementary savings scheme.

10.5 Some brief comments on the other systems considered are:

(a) Although there is much support for the increase in State pension to 50% of GAIE as examined in chapter 6, the projected costs are seen to be a significant difficulty.

(b) A mandatory supplementary system as described in chapter 7 will eventually deliver benefits close to the NPPI targets. However, such a system would take about 40 years to provide full benefits, and raises considerable issues of implementation and design complexity. Those complexities remain with this system but the increase in State pension provides immediate benefit to current pensioners and those retiring before the benefits of the supplementary element start to come through.

(c) There is much support for a soft mandatory system as described in chapter 8, especially combining some increase in State provision with a soft mandatory supplementary system. There is, however, concern that the take-up of the supplementary provision would be too low to achieve the desired objectives. Furthermore, in order to encourage participation, the contribution rate would have to be lower than needed for adequate provision.

Costs, benefits and impacts

10.6 Table 10.6.1 compares the total projected benefits provided under this system with those projected under the current pension system, i.e. the total pensions paid, including State retirement benefits. All results are expressed as a percentage of GNP.

Table 10.6.1 – comparison of benefits

	2006	2016	2026	2036	2046	2056
Current	5.2%	6.7%	9.1%	11.8%	15.0%	16.6%
Proposed system	5.2%	7.3%	10.0%	13.2%	17.3%	19.4%

The increase in the projected benefits in the current system is a result of the increased numbers in retirement. Under the hybrid system, the benefits increase further in 2016 almost entirely as a result of the higher State pension. The gradual effect of the mandatory contribution benefits further increases benefits over time. In 2006 values, the increase in benefits in 2016 is about €1.0 billion, increasing to a projected €3.8 billion by 2056.

10.7 Table 10.7.1 below compares the total projected pension contributions under the current system (including personal and employer PRSI contributions) with those under this proposed system. Note that this includes the additional contributions in respect of the increase in the State pension. The table shows these results as a percentage of GNP.

Table 10.7.1 – comparison of contributions, % of GNP

	2006	2016	2026	2036	2046	2056
Current	6.7%	7.0%	6.9%	6.8%	6.6%	6.6%
Proposed system	6.8%	8.9%	8.8%	8.5%	8.1%	8.0%

It is also useful to express the projected contribution costs as a percentage of workforce earnings as follows:

Table 10.7.2 – comparison of contributions, % of earnings

	2006	2016	2026	2036	2046	2056
Current	15.5%	15.5%	15.7%	15.7%	15.4%	15.4%
Proposed system	15.7%	19.7%	19.8%	19.7%	18.7%	18.7%

The projections for 2016 show a significant increase in total contributions, compared to the current system, amounting to about €1.9 billion in 2006 values. This difference is projected to reduce thereafter, as a result of the assumed effect on voluntary provision of the increase in the State pension and the mandatory supplementary system.

Table 10.7.3 compares the projected Exchequer cost of the mandatory system with the projected cost of the current system.

Table 10.7.3 – comparison of Exchequer costs, % of GNP

	2006	2016	2026	2036	2046	2056
Current	2.4%	3.9%	5.5%	5.9%	6.2%	7.0%
Proposed system	2.6%	5.3%	7.0%	7.3%	7.3%	7.8%

The projected Exchequer cost is considerably higher in 2016 as a result of the contributions to the supplementary system as well as the unfunded portion of the additional State pension. The unfunded costs diminish over time, reducing the projected difference between this system and the current system. In 2016 values, the additional Exchequer cost in 2006 is about €1.8 billion.

Further details regarding the cost and benefits are contained in chapter 9. Further projections are provided in tables 61 to 70 of Appendix E.

10.8 The following is a summary of the observations on this system made by Fitzpatrick Associates in their report:

- Potentially highest costs of implementation.
- Still some potential for negative external perceptions of additional taxation
- Labour market impact more significant than purely supplementary scheme.
- Guarantees greater minimum income in retirement.
- Guards against regressive impacts with lower income threshold.
- Stops higher income groups from using scheme as alternative investment option.

The full text of their report is given in Appendix A.

10.9 Any change to supplementary pensions can potentially increase complexity and may have unintended consequences. The Board would therefore be in favour of further study of the detailed implementation of the supplementary mandatory system proposed, in combination with appropriate public consultation before the system could be introduced.

A number of relevant implementation issues were identified in chapters 6 and 7. The Board's current views on these topics are:

(a) A number of the Board members are in favour of increasing the contribution to the NPRF sufficiently to cover the entire long-term cost of the increase in the State pension. The amount of this increase is estimated to be about an additional 1.3% of GNP, or about €1.7 billion per annum. However, other Board members are not in favour of pre-funding these payments.

(b) Those who are making existing adequate occupational pension provision or have sufficient savings would not be required to contribute to the Special Savings for Retirement scheme. Detailed regulations would be required to define an adequate alternative and appropriate certification procedures must be designed and supervised.

(c) Sections 7.20 to 7.24 discussed possible models for the collection of supplementary contributions under a mandatory system. The Board's initial view favours the use of the PRSI system for collection, but recognises that considerable further investigation is needed.

(d) There is a range of views about what the upper limit for eligibility should be. An upper limit of twice GAIE was adopted for the purposes of preparing projections, but there was support for setting this limit at 3 times GAIE or approximately €90,000.

(e) The Board's initial view favours the investment of contributions by the State, possibly through the National Treasury Management Agency.

(f) Some Board members believe that it would be appropriate to provide investment guarantees for contributions to the Special Savings for Retirement scheme. Such guarantees could provide a minimum investment return, or could provide a minimum retirement income, which would provide a minimum defined benefit. As discussed in section 7.17, there is a wide range of potential approaches, which require detailed assessment.

(g) The Board notes that the introduction of the Special Savings for Retirement system would require an increase in the regulatory resources needed to ensure compliance. This may include some or all of the Pensions Board, the Financial Regulator, the Revenue Commissioners, the Department of Social and Family Affairs, and possible other bodies.

10.10 The Special Savings for Retirement system outlined in this report could:

- improve retirement incomes for all existing and future retirees;
- encourage additional saving for retirement for those in the workforce.

10.11 The Board believes that the operation of the scheme should be carefully monitored so that any changes can be made in light of progress towards objectives and changes in circumstances affecting pensions. This may be the case if the scheme has any unforeseen effects.

10.12 While further consideration will need to be given to some of the implementation issues, the report provides a realistic picture of the practical implications of introducing such a system from a range of perspectives. In conjunction with the findings of the NPR, the Board believes that the up-to-date costs and projections shown in this report and its conclusions and recommendations will make a sound contribution to future decision making on pension provision. The Board is available to provide appropriate elaboration on any issues which the Minister considers relevant and to develop approaches to meeting the objective of adequate retirement provision for all.

Appendices

Appendix A – report by Fitzpatrick Associates

Appendix B – report by ESRI

Appendix C – soft mandatory systems

Appendix D – report by Life Strategies

Appendix E – Life Strategies projection results