One Nation in Old Age

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With the new pension levy for public servants, the government admits that pension policy can play a small role in curing the nation's malaise of budget imbalance and social injustice. They are wrong: pension policy can play a crucial role.

It is difficult to achieve a consensus around the inverted socialism of our times, when the wealthy are bailed out by the less wealthy. It rankles with the majority. But is there another way to raise the billions needed over the next few years while, at the same time, maintaining social cohesion?

The purposeful complexity of our current pension system is hiding an outrageous redistribution of resources towards the better off. All that needs to be done is to lift the concealing veil, and a palatable solution will be obvious to all. Redirecting that inequitable redistribution would go a long way towards ending our current financial woes.

There are three nations in old age in Ireland: the majority who rely almost entirely on the state pension, the minority who have adequate supplementary pensions, and those others who misguidedly think that they have adequate supplementary pensions. A gentle tug at the veil reveals that all deficits in defined benefit schemes (c.€45 billion) are not real 'deficits', because nobody is there to make them up: there are only deficient pensions. And those other pension savers, recently granted a couple of years longer to continue to court investment risk, are not acting appropriately for the risk aversion that comes with age.

Lift the veil higher and it reveals that the social injustice of our top-up pension structures comes, not primarily from the unrealistic expectations engendered, but from who bears the cost of the top-up. The higher the income of the pension saver the higher the percentage borne by the general taxpayer, with an effective subsidy of one-third of savings for someone on a salary of €100,000, reducing to one-fifth for someone on the average industrial wage and nothing at all for someone with no or little income. The annual subsidy is a couple of billion and, of course, the vast majority of that sum goes to those in the highest income deciles.

Pull the veil off altogether and we understand why it was allowed settle for so long over such an important part of our society. Government ministers and their civil servants, charged with looking after the nation's interest, were looking after their own. There is another couple of billion implied subsidy to public servants' pensions per annum. Public sector pensions – indexed to wages, often payable from age 60, and state-guaranteed - are the most generous in the world, exceeding that of, say, UK civil servants. And wages in the public sector are not appropriately adjusted to reflect the value of pension benefits: the Report of the Public Benchmarking Body in December 2007 provides an appendix that shows, on a fair value basis, that the cost of the pension exceeds that finally imputed by the Benchmarking Body by more than recent pension levy. That report at least gave the reader the numbers. The Review Body on Higher Remuneration in the Public Sector Report in September 2007, when looking at the extraordinarily higher pensions given to government ministers, secretaries general, judges, university presidents, etc., decided not to take it into account because (3.31) "if the Review Body were to apply a greater discount to these groups than to groups in receipt of standard [public sector] pension terms, this would effectively cancel the value of the special terms by reducing salary to take account of them"!

To reform this big complicated mess of a pension system, that allows such inequities and nonsense, requires a simple plan. Over the last five years, despite all the reports and investigations, nothing as innovative as Jim Kehoe's original suggestion has been put forward. Prompted by his original idea, we suggest the following blueprint of a new pension system:

(1) State pensions – contributory, non-contributory and retirement – should remain more or less as they are now, but made equal in value, the qualifying

terms significantly simplified, and a credible guarantee given that it will be indexed to average wage increases in the future. So, this pension will, accordingly, be set at one-third the average wage in Ireland, be universal or near-universal in coverage, be payable from age 65 and will not require retirement of the individual. This pension is the bronze pension.

(2) The state will administer a voluntary top-up scheme, where each one-off contribution by the individual buys a pension from age 65 of one-fifteen of that amount. That is, a €100 contribution from an individual buys a pension of €6.67 per annum from age 65, increasing in line with average earnings both pre- and post retirement. This requires a 40% subsidy by the state to make it cost neutral (properly costing for the state guarantee). Note that there is no employer contribution.

(3) The top-up scheme has a limit to the pension payable of 2/3rd the average wage in Ireland, so (1) and (2) combined gives a maximum (state subsidised) pension equal to the average wage in Ireland. This maximum pension is the gold pension. Equivalently, the maximum voluntary pension savings (through the state subsidised) scheme over a working lifetime is ten times average annual earnings in Ireland (i.e., 10 times one-fifteenth equals two-thirds)

(4) A silver pension is a pension of 2/3rd of the average wage in Ireland – half way between bonze and gold – and requires a total lifetime savings of 5 times the average annual wage in Ireland. The state will actively encourage workers to provide a silver pension for themselves and their families, through specially structured savings schemes.

(5) To ensure the credibility and sustainability of the new system, the state will invest any top-up contributions until drawdown and, in addition, maintain a stability fund for the bronze pension so that contribution rates are immune to likely demographic shifts. The costing of a lump sum of 25 units buying a wage-indexed pension of 1 unit from age 65 (with cost split 15 units for individual, 10 units for state) is estimated to be cost neutral if the contributions are invested in low risk investments.

(6) Pension rights (including the rights to increases in line with increases in average wages) must become contractual rights, so they can be enforced through the courts.

(7) The above is then the sole state-incentivised pension top-up structure and all the other structures and incentives are abolished – so no tax relief for individuals or employers, no lump sum payments, no public sector pensions.

So how do we get from where we are now to the brave new world, where everyone is treated equally when it comes to providing for old age? Key transition arrangements are:

(a) Accrued moneys under existing pension arrangements can buy into the top-up scheme at the conversion rate of a wage-indexed pension of $1/20^{th}$ of the sum transferred. This one-off conversion factor errs on the generous side, as this money already received tax-relief. However, once the maximum gold pension is purchased, the remainder of the pot, if any, is taxed and paid as income. Alternatively, the individual may wish to maintain the arrangement to date, but now it will be taxed as normal savings with no tax relief on future contributions.

(b) The above conditions apply to funded defined benefit schemes. As many will be unable to buy out accrued entitlements given their current funding position, the government will accept an unsecured corporate bond from the sponsoring employer equal to the deficit on a (revised) MFS standard, repayable in equal instalments over a term of 10 years. Employers should jump at this as, amongst other things, future benefit accruals cease – so helping them afford to make good the deficits.

(c) Pensions entitlements already accrued in the public sector are honoured up to the gold pension. Accrued entitlements above that are commuted at a rate of 15-1, and repaid in instalments as a temporary allowance.

(d) Wage increases in lieu of previous accruing pension benefits, which will offset to a varying extent the future cost of silver or gold pensions, to be negotiated locally.

The above system is one based on social justice, not socialism. All it does is ensure that everyone is given an equal opportunity to save for a pension and, controversially, are given equal subsidises. The individual is responsible themselves for any top-up above the bronze pension. True, the scheme limits the amount of subsidised pension to the average wage in the economy – anything above that being considered an extravagant retirement. People can, of course, provide themselves with an extravagant retirement – but the rest of us should not be compelled to subsidise it.

A move to the new system involves an enormous flow of funds into the state pension scheme – about €100 billion. Only about €75 billion of that needs to be invested to ensure that the new system is financially sustainable. In future years, the annual inequitable redistribution of five billion or so euros within the economy will also cease, promoting social cohesion and could even help reduce budget imbalances.

The plan presumes only that the nation still has an appetite for social justice: to fight against the governors, who govern for themselves; to fight against the civil servants, who serve themselves; to fight against the peddlers of investment risk, who promise only investment rewards. The Old Age Pension introduced a hundred years ago gives hope: it overcame all those obstacles and even one more - it got the rich to pay for the pensions of the poor. Our proposal, to enable individuals to provide from themselves on an equal basis, is comparatively modest. Nor does it take much time or paper to move to the brave new world: the original Old Age Pensions Act ran to just a dozen straightforward clauses and, after enactment on 1st August 1908, pensions were paid from 1st January 1909.