17 Kildare Street,
Dublin 2
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PUBLIC CONSULTATION PROCESS FOR AN AUTOMATICE ENROLMENT RETIREMENT SAVINGS SYSTEM

EXECUTIVE SUMMARY

ISME welcomes this consultation by the DEASP in addressing the massive pensions shortfall among workers in the private sector. It is a welcome start, but does not go far enough, in that it fails to tackle the issue of the unfunded liabilities for public service and social protection pensions. Together, these liabilities total more than €450bn, which is more than twice the size of the Irish national debt. While we acknowledge the pension benefits of an Automatic Enrolment (AE) for the employee, the funding mechanism as structured in the strawman proposal will have a negative employment impact, especially for lower paid workers. DEASP must 'own' this impact, and explain to the public why it must be borne.

The quantum of proposed the State contribution to the AE scheme is miniscule by comparison to its massive subsidisation of public service pensions, and would be a maximum of €1,125 per worker per annum. This would not encourage those who currently contribute to their personal pension to migrate to the AE scheme.

The unfunded pensions liabilities of the State are the largest threat to its long-term financial stability, and the DEASP remains the largest-spending Government department. It is therefore imperative that the DEASP receives robust, honest, independent and objective advice on addressing the entire pensions issue (and not just private sector pension coverage) from the ESRI and/or NTMA, as well as the advice of external consultants not on the public payroll.

The AE scheme should be the first step taken to bring equivalence between public and private sector pensions according to the Revenue's pensions and tax evaluation criteria. DEASP should commit to elimination of the apartheid between public and private sector with a fixed period of time.

If we are to maintain private sector confidence in a State-sponsored AE system, the State must unequivocally commit to never again expropriating private sector pensions savings.

ISME AND A URSS

ISME is delighted to take this opportunity to respond to the AE consultation by DEASP. Over many years, ISME has lobbied for a universal retirement savings scheme (URSS), to address the massive pension deficit in Ireland. Broadly, ISME argued that such a scheme should have the following characteristics:

- All workers, employed and self-employed should be included.
- The cost of the scheme should not add to the cost of labour to employers.
- In order to encourage up-take, the State must contribute to the scheme.
- The State must be the main agency involved both in the collection, recording, investing and distribution of benefits.
- Consideration should be given to including public sector employees in the scheme, i.e. there should be pensions equity between all workers, whether employed by the State, employed in the private sector, or self-employed.
- The scheme should be mandatory auto-enrolment with limited opt-outs.

We can see that the proposed scheme attempts to address some, if not all of these objectives. We note, however, that while the scheme addresses the issue of the lack of penetration of pensions cover in the private sector, it does not address the massive unfunded pensions liability that exists for the pay-as-you-go public sector, contributory and non-contributory old age pensions. Failure to address this liability now will materially constrain national fiscal policy for the coming four decades.

PRINCIPLES

Regarding the five principles set out in the strawman proposal's forward, ISME comments as follows:

1. **CHOICE:** we accept the principle as expressed of all-in automatic enrolment (within the thresholds) with opt-ins for those who do not meet the initial criteria.
2. **COMPETITIVE RETIREMENT SAVINGS PROVISION:** We are conscious of the fact that many providers currently exist. Notwithstanding that there is a large number of current providers, we believe it would be imprudent to be too prescriptive at an early stage about defining all the market channels for the scheme. It could be that there would be a useful co-existence between a small number of large registered providers and a broker base who would direct users to all but the default option. However, the administrative cost proposed, at 0.5%, will attract only high-volume providers.

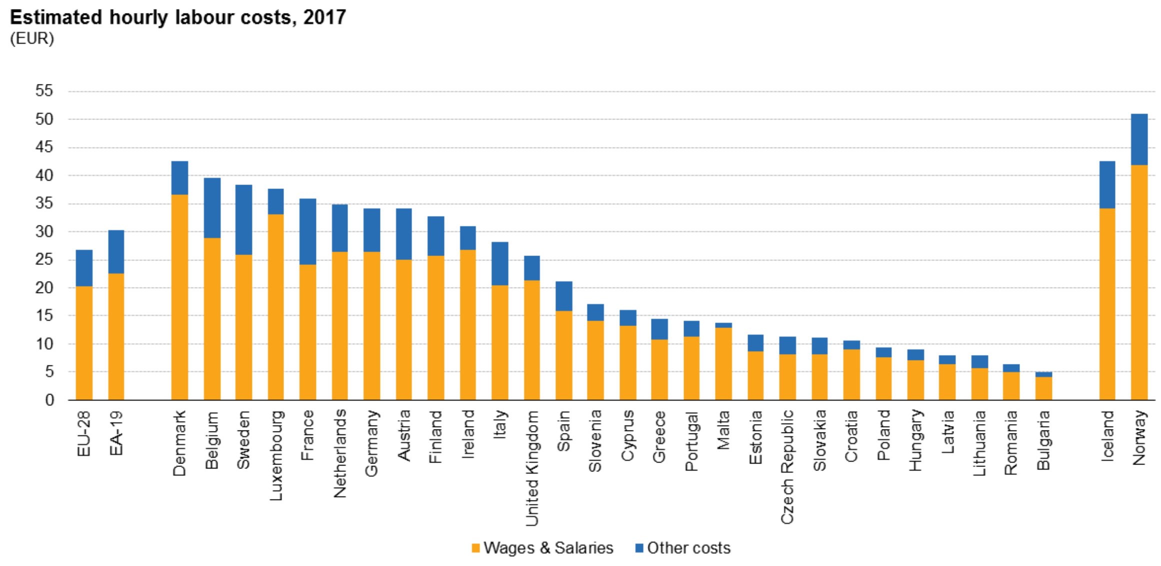
3. **DEFAULT PRODUCT:** A default product is a good idea, which we suspect will be availed of in most cases.
4. **FINANCIAL SUPPORT:** The proposed level of Exchequer matching support for employee subscriptions, while not remotely as generous as that provided to public sector workers, means that there will be a positive inertia not to exercise the opt-out option.
5. **SIMPLICITY/TIMELINESS:** This is absolutely essential, and should not burden employers. It is vital that the scheme is seen as a personalised extension of the social insurance system, and that administration and queries do not become a matter for the employer to handle.

LABOUR COST IMPACT

Firstly, while it will seem entirely reasonable to some for employers to contribute pro-rata with employees, this will directly impact the cost of labour. This argument is invariably framed around the statement that Irish employers pay one of the lowest rates of social insurance on wages in the EU. It is also true, however, that the wage/salary cost borne by Irish employers is one of the highest. It is, in fact, fourth in the EU, lagging only Denmark, Luxembourg, and Belgium, none of which are peripheral economies (Figure 1). SMEs in Ireland have a far higher labour component in their cost of sales than large or multinational enterprises. In the case of some small service businesses, labour & benefits costs can be up to 86% of location sensitive costs. For the avoidance of any doubt, ISME is stating clearly that if employers' PRSI rose from its current 10.85% to 16.85% (at the year 6 contribution level) a material labour-force impact would be inevitable. We are not saying what that impact will be, as it would be entirely dependent on macroeconomic conditions prevailing at the time. There is, as a matter of simple fact, a trade-off between the cost of labour, and the amount of labour used in the Irish market.

With Brexit approaching, we feel it is pertinent to point out that we are faced with a national minimum wage of £7.83/hr in Northern Ireland (€8.89/hr at a rate of €1:£0.88) while ours is currently €9.55/hr.

Figure 1.



Note: whole economy (excluding agriculture and public administration); in enterprises with 10 or more employees. Provisional data.
Source: Eurostat (online data code: lc_lci_lev)

It is incumbent on DEASP to acknowledge and plan for the employment effects of an increase in labour costs, since the Department will be held accountable for that cost, and will own any labour effects. ISME has previously shared with the Low Pay Commission the detailed study of the labour effects of the increase in the minimum wage carried out by the University of Washington (UW)[1].

The UW study focussed on the impacts of Seattle's minimum wage ordinance on wages, workers, jobs, and businesses throughout 2015. The study is highly significant from an Irish perspective because:

- Washington State is comparable in size and population (albeit larger in both) to Ireland.
- It is a largely rural state, but with a large, high-tech city on its seaboard (Seattle).
- In the period of study, the regional economy was on an upward trajectory, especially in Seattle.

In 2015, the City of Seattle increased its minimum wage considerably, from $9.47/hr to $11.00/hr. This increase was applied in the City of Seattle only, i.e. it was not a state-wide ordinance. UW conducted a significant longitudinal study of the effects of this wage increase, with the stated objectives of ascertaining:

1) How has Seattle's labor market performed since the City passed the Minimum Wage Ordinance, and particularly since the first wage increase phased in on April 1, 2015?

[1] The Seattle Minimum Wage Study Team. 2016. Report on the Impact of Seattle's Minimum Wage Ordinance on Wages, Workers, Jobs, and Establishments Through 2015. Seattle. University of Washington.

2) What are the short-run effects of the Minimum Wage Ordinance on Seattle's labor market?

It is worth extracting some of the summary findings of the UW study of the effects on wages, low-wage workers, jobs and businesses:

Wages:

- *The share of workers earning less than $11 per hour declined sharply.*
- *However, similar declines were seen outside of Seattle,* [i.e. where the minimum wage was NOT increased] *suggesting an improving economy may be the cause of the change in the distribution of wages.*

Low-Wage Workers:

- *…the City of Seattle's lowest-paid workers experienced a significant increase in wages.*
  - *The minimum wage contributed to this effect, but the strong economy did as well. We estimate that the minimum wage itself is responsible for a $0.73/hour average increase for low-wage workers.*
- *In a region where all low-wage workers, including those in Seattle, have enjoyed access to more jobs and more hours, Seattle's low-wage workers show some preliminary signs of lagging behind similar workers in comparison regions.*
  - *The minimum wage appears to have slightly reduced the employment rate of low-wage workers by about one percentage point. It appears that the Minimum Wage Ordinance modestly held back Seattle's employment of low-wage workers relative to the level we could have expected.*
  - *Hours worked among low-wage Seattle workers have lagged behind regional trends, by roughly four hours per week, on average.*
  - *Low-wage individuals working in Seattle when the ordinance passed transitioned to jobs outside Seattle at an elevated rate compared to historical patterns.*
- *Seattle's low-wage workers did see larger-than-usual paychecks (i.e., quarterly earnings) in late 2015, but most— if not all—of that increase was due to a strong local economy.*
  - *Increased wages were offset by modest reductions in employment and hours, thereby limiting the extent to which higher wages directly translated into higher average earnings.*
  - *At most, 25% of the observed earnings gains—around a few dollars a week, on average—can be attributed to the minimum wage.*

Jobs:

- *For businesses that rely heavily on low-wage labor, our estimates of the impact of the Ordinance on the number of persistent jobs are small and sensitive to modelling choices. Our estimates of the impact of the Ordinance on hours per employee more consistently indicate a reduction of roughly one hour per week.*
  - *Reductions in hours are consistent with the experiences of low-wage workers.*

In sum, Seattle's experience shows that the City's low-wage workers did relatively well after the minimum wage increased, but largely because of the strong regional economy… Although the minimum wage clearly increased wages for this group, offsetting effects on low-wage worker hours and employment muted the impact on labor earnings.

From an ISME perspective, this confirms the simple, factual observations our members have made to Government for many years; that we inhabit a high-cost economy, with high labour costs. While, in an expanding economy, an AE pension system might have a low or negligible effect on overall employment levels, as the labour market tightens, the increased cost of labour will have a detrimental effect on employment levels; *or*, on the total hours worked by employees in some industries.

By way of current example, ISME understands from members in the construction industry that while the introduction of a Sectoral Employment Order for 'Category 1' workers[2] in the construction sector has mandated an increase in the hourly rate of pay to €17.04 per hour, this has not increased total weekly pay ('P60' pay) for many workers. Some companies have simply been unable to pay that rate for general operatives.

According to the NCC, up to 86% of the cost of sales in an SME can be labour cost.[3] Bearing in mind that the Eurostat data on which the NCC bases its output excludes micro enterprises, the employment impact of the AE proposal would be significant.

ISME is already aware of multiple member companies who can source intellectual labour for their business abroad, within the EU, at hourly rates of pay that are substantially below those payable here. If the trend of continually ratcheting up labour costs in Ireland continues, we will encourage a ghettoization of labour in the country, where the low-skilled workers effectively become too expensive to hire by most enterprises, and even more highly-skilled workers (accountants, lawyers initially) find themselves displaced by workers employed remotely within or beyond the EU. Of course, where productivity is on the table, labour cost effects can be mitigated.

In considering the labour cost impact of an AE system, it is noteworthy that ISME is the only independent trade association for small enterprises in the country, yet is not represented on the Labour Employer Economic Forum (LEEF). ISME suggests that it is imprudent for DEASP (and by extension DPER) to contemplate a measure with such far-reaching consequences for domestic employers when the voice of the majority of them is absent from the table.

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[2] https://www.workplacerelations.ie/en/news-media/Workplace_Relations_Notices/Minister_Pat_Breen_signs_Order_to_increase_pay_for_workers_in_the_construction_sector.html

[3] http://www.competitiveness.ie/Publications/2018/Ireland-s-Competitiveness-Scorecard-2018.pdf

<u>**UNIVERSALITY**</u>

In its previous papers and pre-budget submissions, one of the key requirements ISME had for a national retirement savings system was that it should be universal. The AE as structured in the strawman proposal ignores the elephant in the room, which is the unfunded long-term liabilities for public service and social protection pensions.

As ISME has previously suggested, a universal retirement savings system as proposed in this scheme should become the de facto universal scheme for all, including the members of the public service. This would tackle the issue of the unfunded liabilities of the Public Service Occupational Pensions[4] estimated at €114.5bn by DPER, and the unfunded liabilities of the Social Insurance Fund (SIF) estimated at €335bn (as of 2015)[5] by KPMG.

This is not just an issue of fiscal prudence, it is a question of equity between public and private sector workers in the eyes of the Exchequer, and the Revenue. Tax allowances for private sector pension contributions are described in the DEASP's own strawman proposal as '*tax expenditures*' and an '*annual subsidy*' (page 36). In the absence of equivalent linguistic descriptors for the burden on Irish society of Public Service Occupational Pensions, such use of language can only be described as deeply disingenuous, as well as displaying a worrying lack of understanding of the actuarial and taxation issues involved.

The notion that the '*tax expenditure*' of €2.4bn on private sector pensions could be recouped or mitigated by reducing tax reliefs demonstrates, to put it bluntly, that the DEASP does not understand the behavioural effects upon pensions saving if they were removed. While it would be difficult to model what the fiscal effect of the removal of pensions tax relief would be, ISME would be very surprised if even 50% of the current '*tax expenditure*' was realised by the Exchequer. In the absence of such an incentive, marginal-rate tax payers, who represent the majority currently enjoying the relief, would be at least as likely to reduce their working time. The '*tax expenditure*' notion also fails to address the issue of double taxation: if income is taxed on the way into a pension scheme, what rate of taxation is applied to income drawn from it at the other end?

Far more worrying, in our view, is the apparent failure to appreciate from a tax-equity perspective the value of the public sector DB pension. As well as the equity issue, we must recognise the long-term liability they

[4] https://www.per.gov.ie/wp-content/uploads/Accrued-Liability-Report.pdf
[5] https://www.welfare.ie/en/downloads/actrev311215.pdf

impose on the state if we are to understand how to fund them. Calculations by the Association of Pension Trustees of Ireland (APTI) show private-sector workers and their employers would have to spend millions of euro to earn the same retirement benefits as workers with similar levels of pension within the public service. Table 1 below shows the open market value of some typical public sector pension entitlements.

Table 1: Open Market Value of Public Sector Pensions

Title	Age starting pension	Retirement lump sum	Annual pension	Value of pension as per Irish Revenue factors	Single life open market annuity cost	Joint life open market annuity cost
Public servant	65	€60,000	€20,000	€580,000	€765,965	€850,514
TD	60	€135,000	€45,000	€1,485,000	€2,108,684	€2,381,630
Garda	60	€102,000	€34,000	€1,122,000	€1,593,228	€1,799,454
High Court judge	70	€255,000	€85,000	€2,125,000	€2,605,664	€2,927,956
Hospital consultant	63	€240,000	€80,000	€2,400,000	€3,328,903	€3,701,705
Senior public servant	65	€150,000	€50,000	€1,450,000	€1,914,914	€2,126,285
Taioseach	66	€378,000	€126,000	€3,528,000	€4,620,424	€5,168,875
Teacher	62	€90,000	€30,000	€930,000	€1,298,703	€1,447,466

The maximum Pension-Related Deduction (PRD) made by public servants to enjoy the DB pensions in the table above is 10.5%. In reality of course, it would take a far greater contribution (c.35%, depending on age) to fund such a pension on the open market. The rest is a simple transfer from the Exchequer to the public sector pensioner. Despite the Revenue evaluations above, public sector pension funds worth more than €2m are not subject to the Standard Fund Threshold. Also, there is no 'capping' of the public service pension as income goes up, while private sector workers cannot avail of tax relief on their pension contributions above €115,000 per annum.[6]

It is also deeply frustrating that this is ground which has been gone over before. At the time of our last deep fiscal crisis, the Government commissioned the *Report of the Special Group on Public Service Numbers and Expenditure Programmes Volume I*, more commonly referred to as 'An Bord Snip;' which carried out an in-

[6] https://www.revenue.ie/en/jobs-and-pensions/pensions/tax-relief-for-pension-contributions.aspx

depth analysis of state spending, and pointing to where economies could be effected. This quantified the cost to the Exchequer of the pensions shown in Table 1 above as:

- **27% of annual salary** in the case of a typical civil servant employed prior to 2004;
- **31% of annual salary** for a teacher entitled to retire at age 55;
- **33% of annual salary** for a hospital consultant;
- **48% of annual salary** in the case of a Garda member;
- **87% of annual salary** in the case of a High Court judge.

Despite this, the words '*tax expenditure*' and '*subsidy*' are never used in respect of public sector pensioners, although these are literally and fiscally the appropriate words to use. It is therefore very problematic for ISME members to accept the objectivity and probity of those who use such subjective and inaccurate expressions regarding private sector pensions coverage in a consultation as important as the strawman proposal.

This is not an observation made in passing. We raise the issue of universality because, from an actuarial and equity perspective, the AE pension, at maximum contribution level, will contrast with the public service pension as follows:

- **AE pension:**
    - Employee contribution 6%,
    - Employer contribution 6%,
    - State contribution 1.5%, to a ceiling of €75,000 (**i.e. a maximum contribution of €1,125 per annum**)
    - 0.5% administration fee
    - Defined contribution pension (unknown pension level)

- **Public Service Pension:**
    - Employee contribution 10.5% (maximum)
    - State contribution c.35% with no income cap
    - 0% administration fee for pensioner
    - Defined benefit pension (half of final/averaged salary)

When compared in this manner, the AE private sector pension remains vastly less attractive than the public sector pension.

Reflecting the above, the wording used by the drafters regarding private sector pensions makes it explicitly clear that the Minister is not in receipt of robust, reliable and objective advice on the gulf between private and public sector pensions, and the actual cost to taxpayers of the latter. It is therefore imperative that NO initiative on AE is taken without a comprehensive independent analysis conducted by ESRI and/or the NTMA, with external advice from one of the large consultancy houses.

Bearing in mind the fact that our pensions deficit is more than 1.5 times our national GDP, the millions of euro such an analysis would cost would be a drop in the ocean. A critical review of the strengths and weaknesses of comparable systems in New Zealand, Australia, and the recently introduced system in the UK would form an essential part of such a study.

ACCESS CRITERIA TO THE AE SYSTEM

The proposal to permit access to the scheme for the self-employed, and those outside the age and income limits suggested, is most welcome. It would have been perverse and inequitable to exclude self-employed persons who wished to opt in to this system.

There should be no exclusion of those who already contribute to supplemental pensions. There is no logic or common sense to this proposal. If, as several social commentators have suggested, the '*tax expenditures*' on private sector pensions are to be reduced or eliminated, is it not better to achieve this with a carrot than a stick? If the AE scheme is successful, employees would naturally migrate into it, and organically reduce the amount of income flowing into alternative private pension schemes. However, if elimination of the '*tax expenditures*' on private sector pensions is contemplated, it can only be in the context of public sector workers funding their pensions on a basis consistent with, and equivalent to, the Revenue's evaluation of a pension of similar value.

If there is to be an income cap to the AE system, it should not be a fixed, nominal level of income, but should be a multiple of the minimum income requirement. In the AE scheme example proposed, the minimum income threshold is €20,000, and the earnings cap is €75,000. This suggests that there would be arbitrary fiddling with the thresholds by the Finance Minister at budget time. The thresholds must be clear, stable over time, and not amended in a capricious manner by the State. In the event that an income cap is imposed, it would be more appropriate to have a multiple of the minimum income requirement, say for example five or six times minimum. However, if tax reliefs on private pension contributions are to be eliminated, there should be no salary cap imposed on an AE scheme.

GENERAL

The comment within the proposal that '*employer contributions will continue to be deductible for corporation tax purposes*' suggests that someone within the DEASP considered that an alternative position was viable. The notion that someone considered a state-mandated labour cost to be anything other than a deductible is quite baffling. See our comments on professional external advice above.

ISME wants this proposal to succeed. But the success or failure of the AE scheme will rest on its absolute trustworthiness for both employees and employers. It will be up to DEASP to enshrine measures to assure private pension holders that the expropriation of €2.3bn from pension funds that commenced in 2011 will not be repeated. While this expropriation ultimately ended, it left private sector workers with the lingering sense that constitutional property rights were rigidly applied to the unfunded DB pensions of the public sector, but the private sector workers' contributions to their DC schemes were fair game if the Exchequer needed some money. Any repeat of this, or any flexibility within the AE system that would permit it in the future, would be fatal for the ultimate success of the system. If there is anything other than complete confidence that a long-term personal retirement savings system will not deliver for the employee, it is doomed to fail. The AE scheme will need to absolutely guarantee a safe return, and low administration costs for employees, and a zero administration cost for employers (who will simply and rightly regard this as an extension of the social protection system). The State will therefore get only one opportunity to get this right.