Irish Fiscal Advisory Council

Saving for Ireland's Future: Building a Sustainable Framework to Fund the State Pension

Killian Carroll and Sebastian Barnes

30th March 2023

Path for the Public Finances Conference 2023

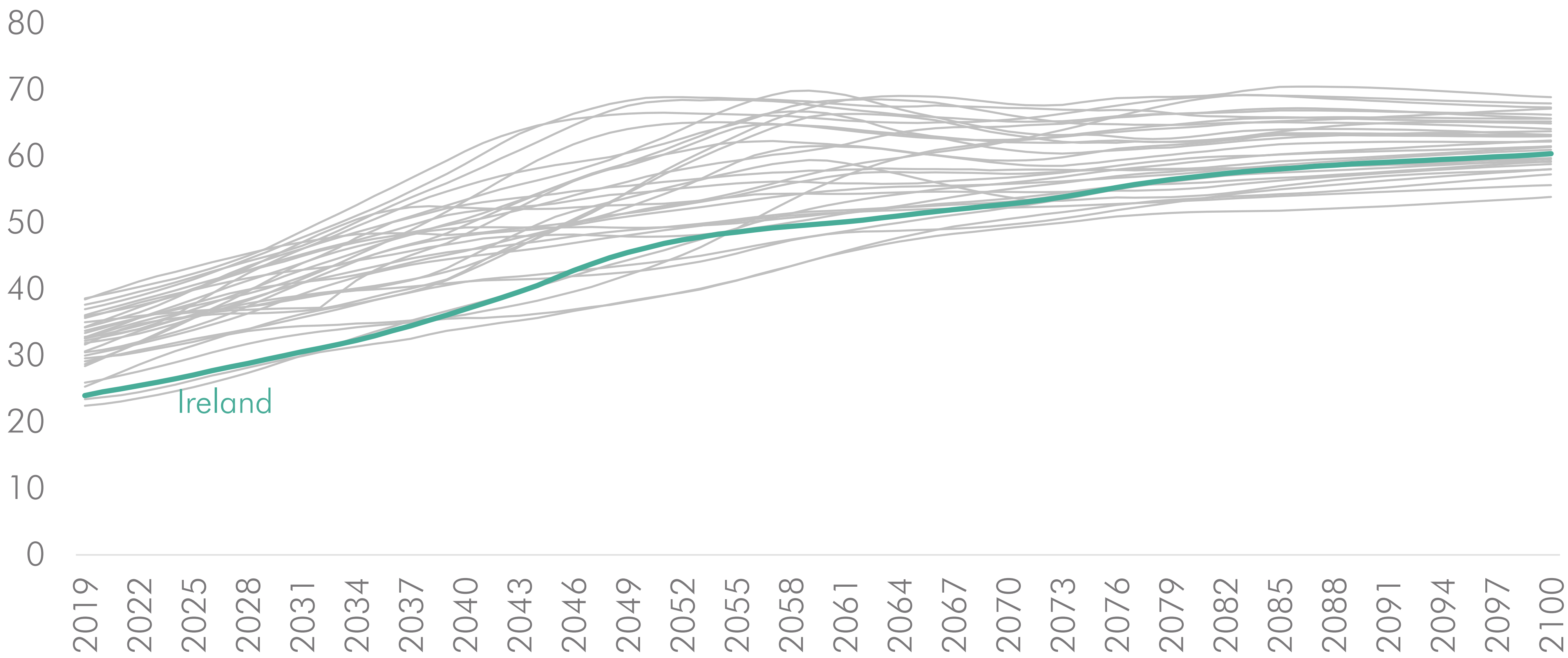
Overview

- The funding of the State Pension will come under increasing pressure in the coming decade as the population ages.
- This requires a long-term approach to managing and funding the pension system.
- One approach: Create a separate State Pension Fund to support the State Pension and fund this through a steady-state PRSI rate.

Background and context

Ireland's old-age dependency ratio is set to rise rapidly

Old-age dependency ratio (population 65+/population 20-64)*100

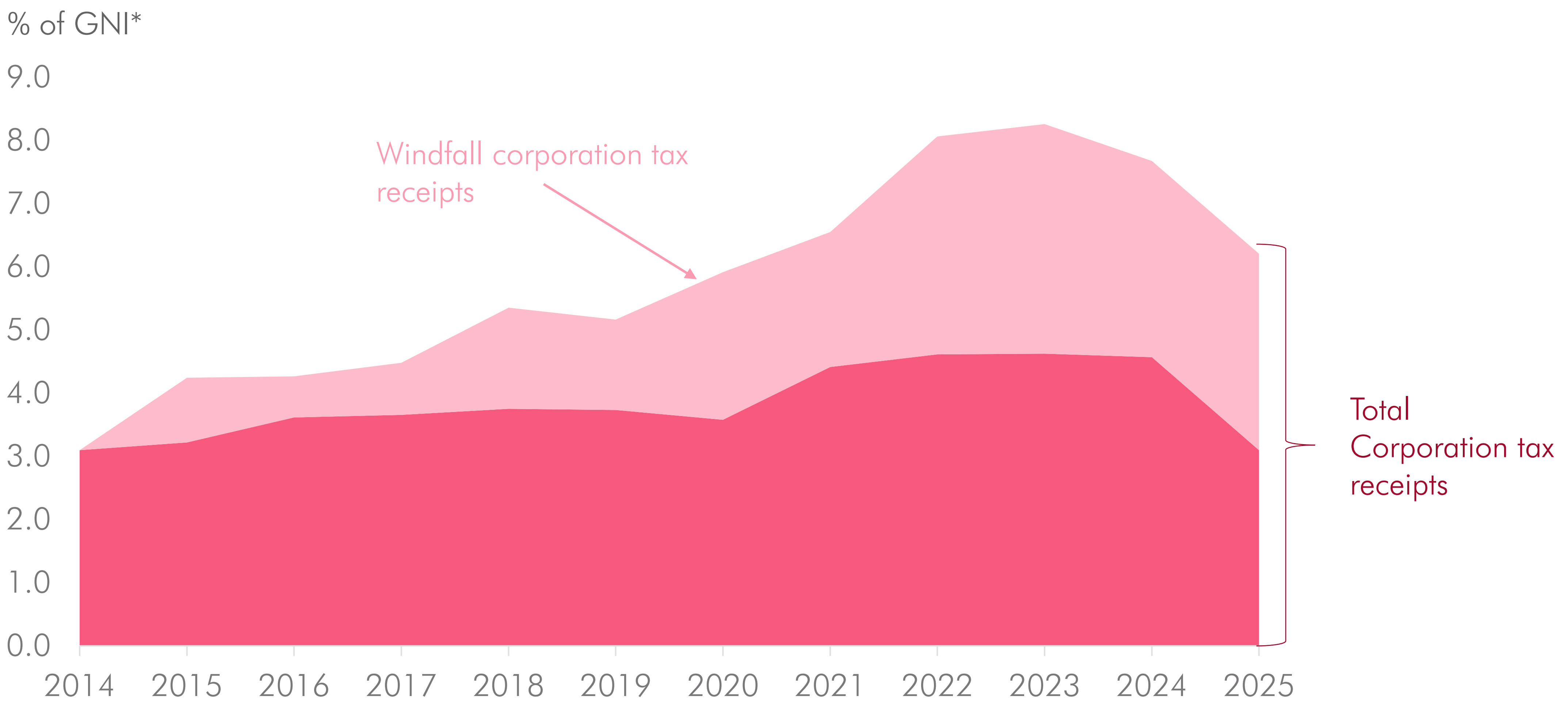


Sources: Eurostat.

Notes: Figure shows the old-age dependency ratio (population 65+/population 20-64) for the EU 27 and EFTA countries in grey.

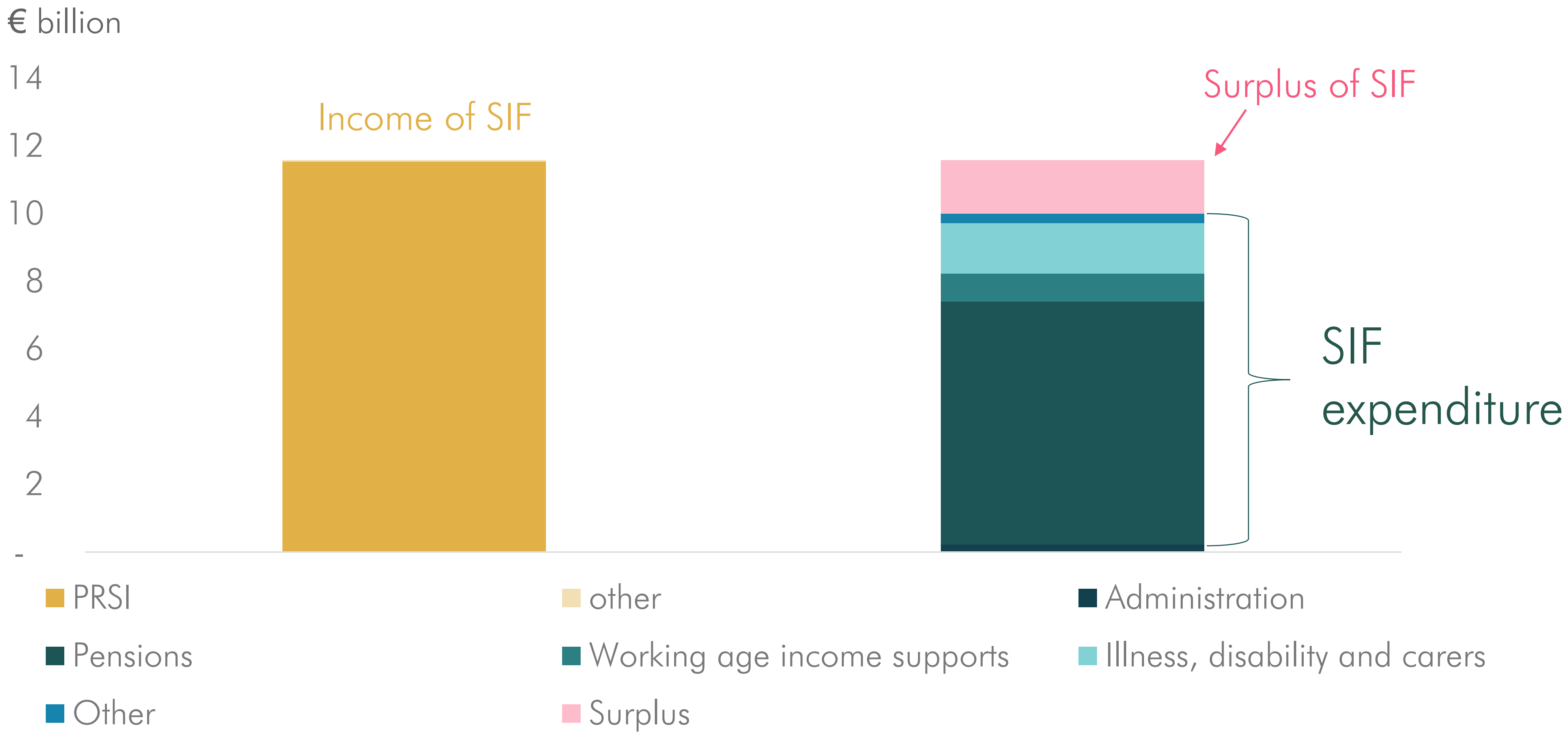
Irish Fiscal Advisory Council

Windfall corporation tax receipts



Sources: Budget 2023, Fiscal Monitor.

The State pension is largely funded out of the Social Insurance Fund (SIF)



Sources: Financial Statement's of the Social Insurance Fund.
Notes: Data is from 2019, prior to the Covid-19 pandemic.

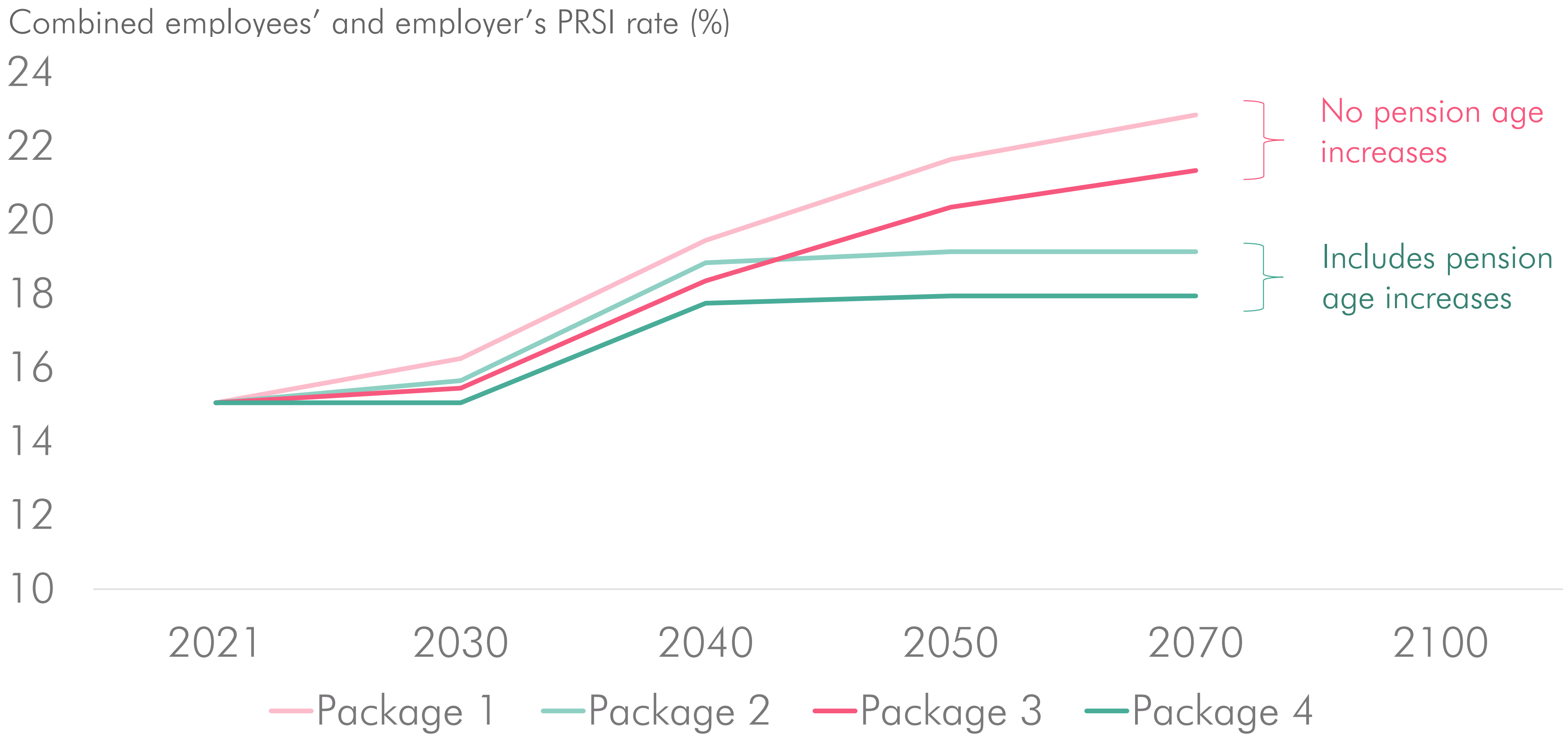
Irish Fiscal Advisory Council

Current policy state of play

- Pension Commission reported in 2021 and put forward 4 packages to ensure the sustainability of the SIF by keeping income and expenditure aligned.
- They recommended the adoption of a package which included PRSI increases, Exchequer contributions, and increases in the State pension age.
- In September 2022, the Government announced that there would be no increase in the State pension age.
- An actuarial review of the SIF is due to be published in H1 2023, with a Roadmap for increasing PRSI rates over the next 10 years.

Irish Fiscal Advisory Council

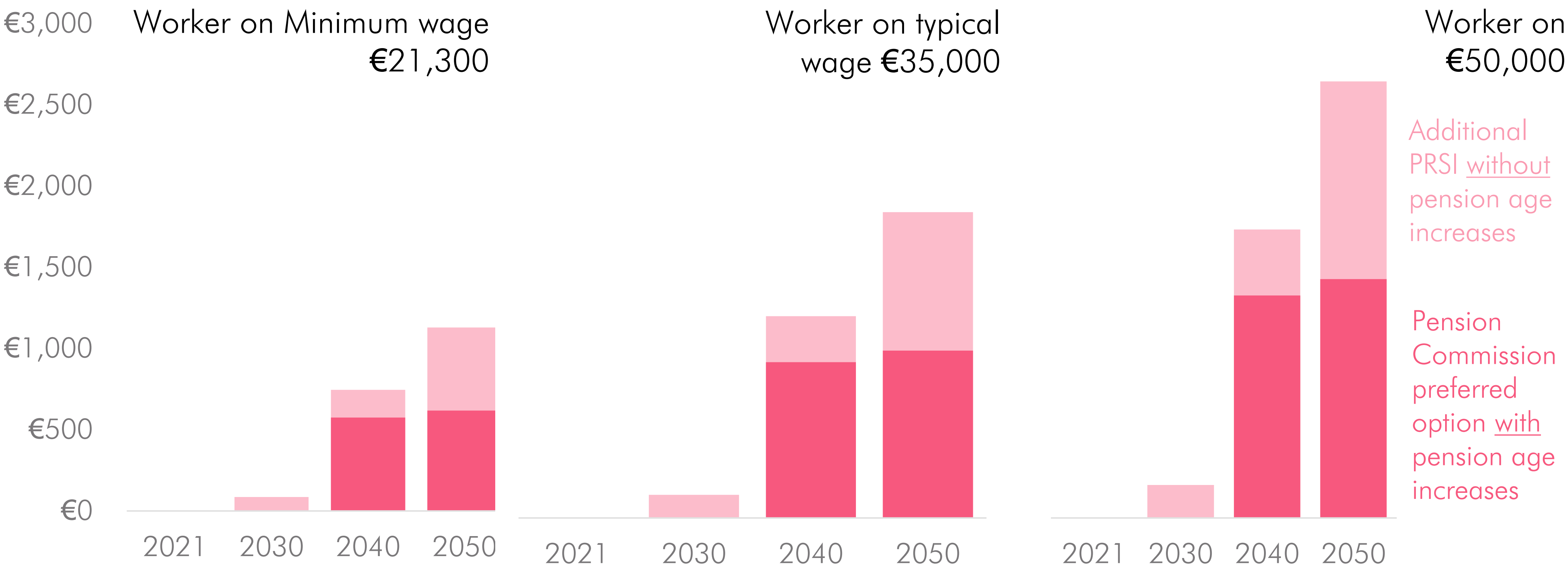
PRSI increases to balance the SIF under the Pension Commission's options



Sources: Pension Commission (2021); and authors workings.
Notes: Package 1 mainly consists of PRSI increases. Package 2 consists of PRSI increases and increase in the State pension age. Package 3 consists of PRSI increases and additional Exchequer contributions. Package 4 consists of PRSI increases, Exchequer contributions and increases in the State Pension age. Package 4 was recommended by the Pension Commission.

Labour cost rises due Pension Commission proposals for increasing PRSI rates

€ change implied for PRSI in today's terms required



Sources: Pension Commission (2021); and Fiscal Council workings.
Notes: Figures are based on Package 4 and Package 3 of the Pension Commission's (2021) options using PRSI rate increases assumed. Figures relate to the rise in labour costs from increasing employee's and employer's PRSI. There is still an additional "Exchequer Contribution" in both packages, which may have to be made up with further tax increases.

Alternative option: “State Pension Fund”

What is the idea?

- A stand-alone pension fund could help improve the management of rising pensions
- The government should be required to set out a detailed and long-term plan for financing State pensions
- This could lead to “Partial funding” model, where reserves are built-up, rather than pure PAYG
- The Canadian approach- a “steady-state” PRSI rate

How would it work?

- Basic idea is that there is an increase in PRSI rates initially, and then no increase thereafter.
- Would result in large reserves being built up and then drawn down
- These reserves would be invested to generate a return
- Steady-state rate revaluated every few years based on new information

Why this approach?

- Potentially lower impact on growth in future years by smoothing PRSI/tax rates over time
- Intergenerational equity – shifts burden away from younger cohorts, which are smaller in size
- Sustainability of the State pension not left to future policy decisions as costs pre-funded
- Can put potentially transitory windfall corporation tax receipts to good use and diversify risks

Modelling

- Based on the Fiscal Council’s Long-term Model (LTM) used in the Council’s *Long-term Sustainability Report* (Fiscal Council, 2020)
- Updated with latest *Budget 2023* forecasts, so modelling starts in 2023
- Extended out to 2100

Modelling

- The LTM only projected out as far as 2050

- Population projections (total pop, pop 65+, pop 20-64, etc.) grown forward with Eurostat growth rates

- Macro variables grown at constant rate from 2050-2100

Irish Fiscal Advisory Council

Modelling: The State Pension Fund

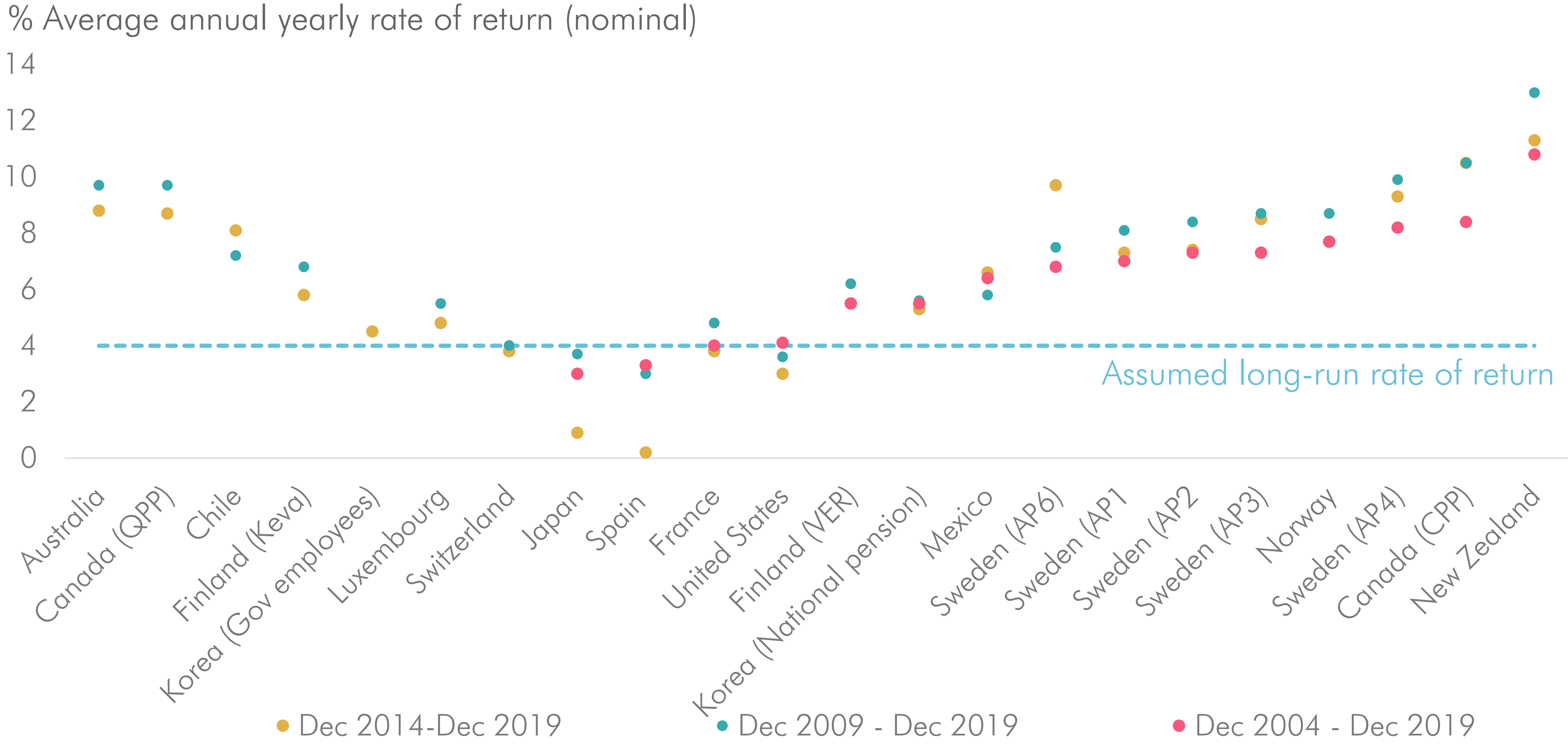
- The SIF includes pension related expenditure and other social insurance benefits
- Separate SIF expenditure and income into the State Pension fund and other SIF expenditure
- Expenditure straightforward. Income split in proportion to expenditure

Modelling

- Pension fund income grows in line with wages
- Pension fund expenditure grows in line with wages and demographics
- Reserves are invested with a nominal rate of return = 4%
- Operationalised through increasing the employees PRSI rate
- Yields from PRSI increases taken from:

  Budget 2022: TSG – PRSI rate setting options

International experience of rates of return for State pension funds



Sources: OECD (2021).
Notes: Data taken from Table 9.4 of OECD (2021).

Irish Fiscal Advisory Council

Modelling: How is the steady-state PRSI rate calculated?

- Several ways to operationalise a steady-state PRSI rate

- One way is to use a very long-time horizon, and set the reserves of the Fund to fall to zero by the very end

- The Canada Pension Plan has an alternative approach, set the contribution rate so that the Asset/Expenditure ratio in year 60, equal to the Asset/expenditure ratio in year 10
  - Asset/Expenditure ratio is the Assets of the Fund in year *t* divided by the expenditure in year *t+1*

Irish Fiscal Advisory Council

Modelling: How is the steady-state PRSI rate calculated?

- We use the same approach as the Canada Pension Plan

- We start in 2023, and stagger (in equal increments) the increase in PRSI so that it is fully implemented by 2027

- To allow the fund to build up, we set the steady-state PRSI rate so that the Asset/Expenditure ratio in year 15 (2038) is equal to the Asset/Expenditure ratio in year 65 (2088)

Irish Fiscal Advisory Council

Compare the results with Pension Commission "Package 1"

- This package is only funded by PRSI increases (no Exchequer contribution, no pension age increase etc.)

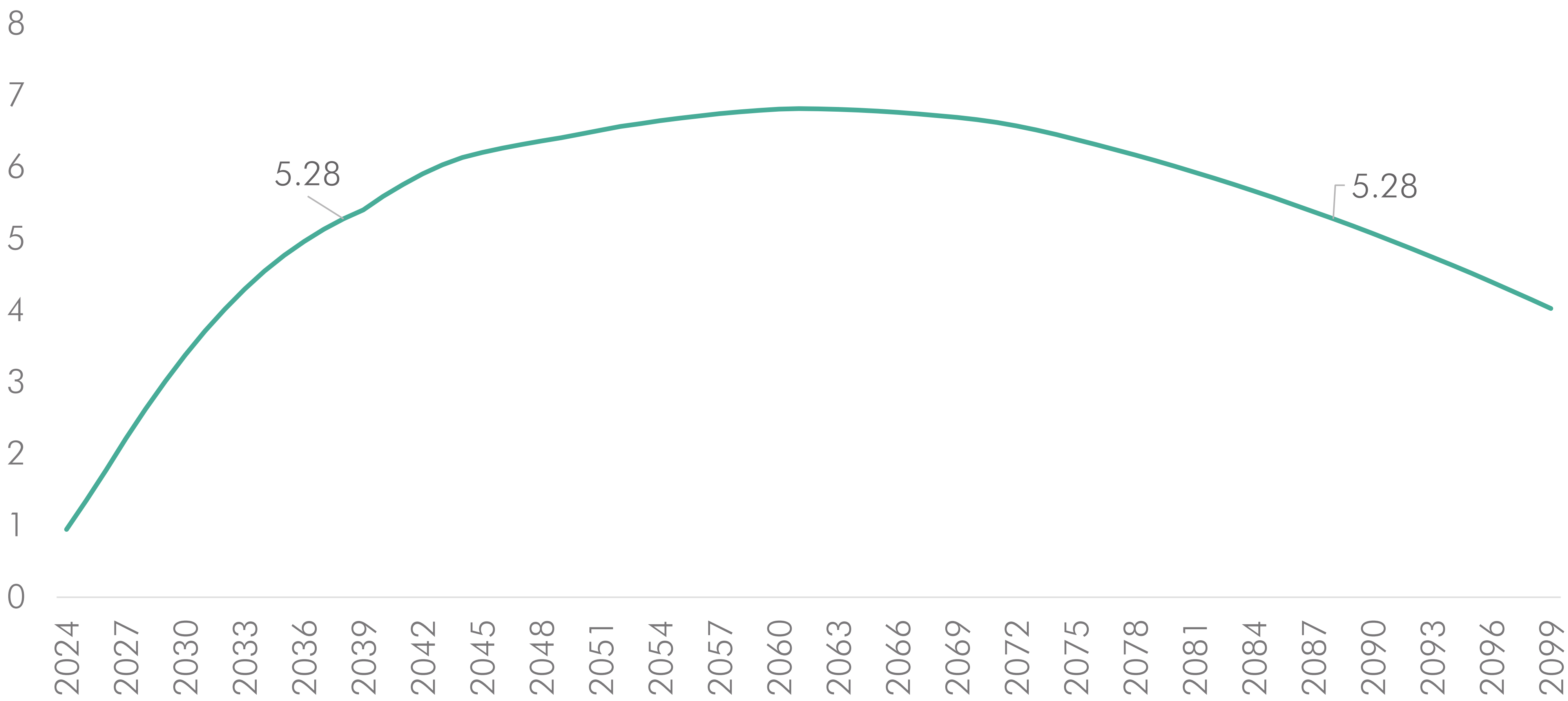
- We incorporate the same switch to Total contribution approach, increases in Self-employed rate, and lower employer's rate, in our modelling in line with what is in package 1

- Compare the "combined" employees and employers (higher) PRSI rates

Baseline results

Baseline results: The Asset/Expenditure ratio

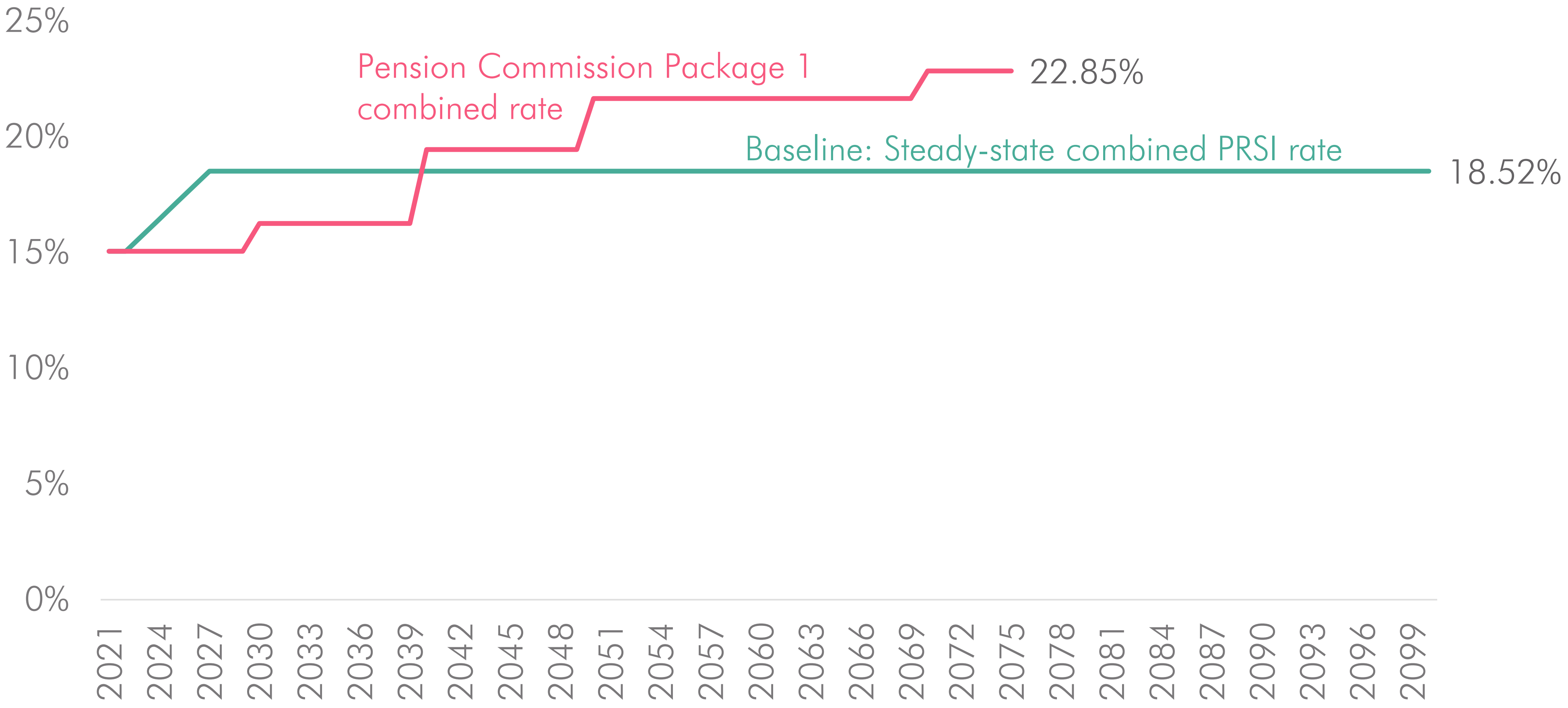
Ratio of Assets in year *t* to expenditure in year *t+1*



Sources: Authors workings.

Baseline results: The steady-state PRSI rate

Combined Employee and higher Employer's PRSI rate



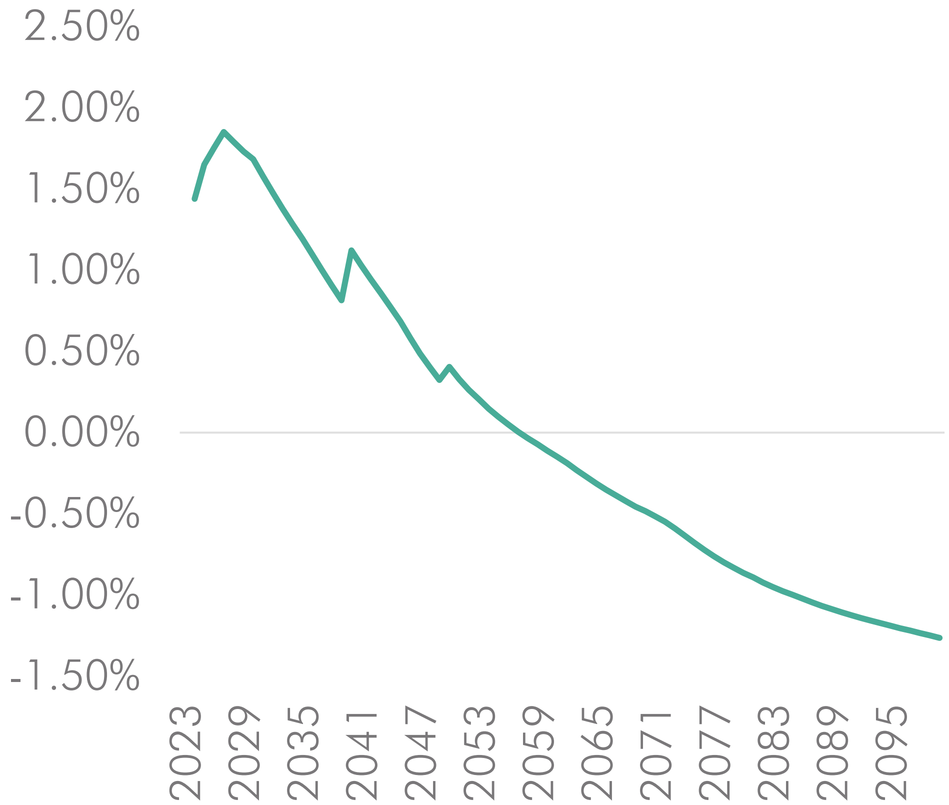
Sources: Pension Commission (2021); and Authors workings.

Irish Fiscal Advisory Council

Baseline results: Fund's Surplus/deficit and Reserves

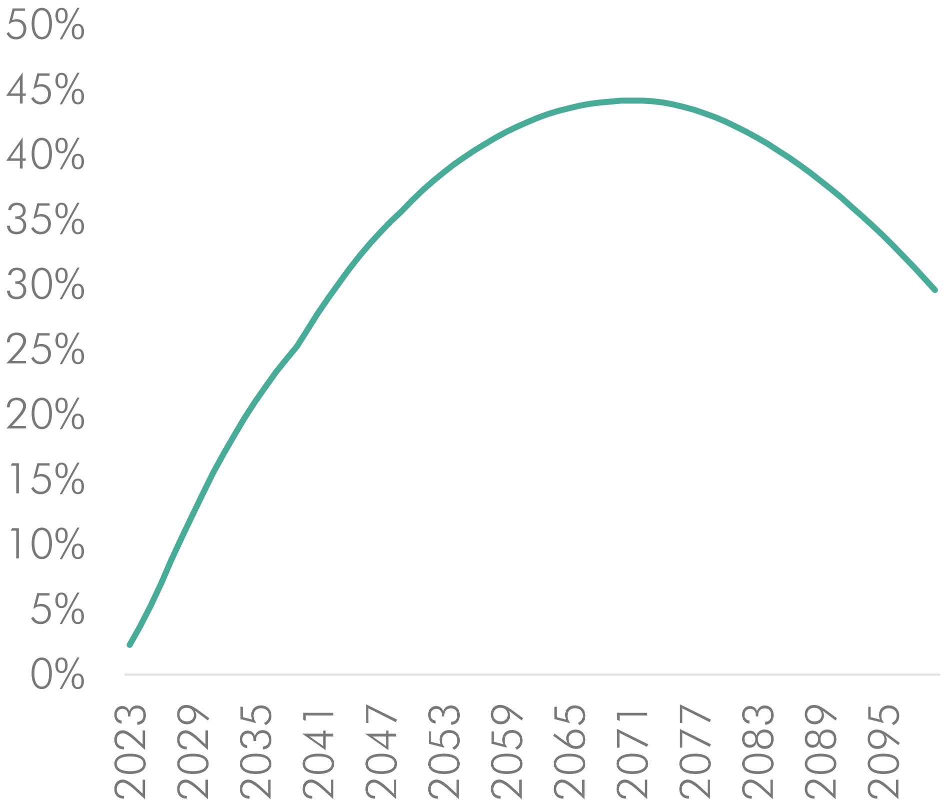
A. Surplus/deficit of pension fund

% GNI*



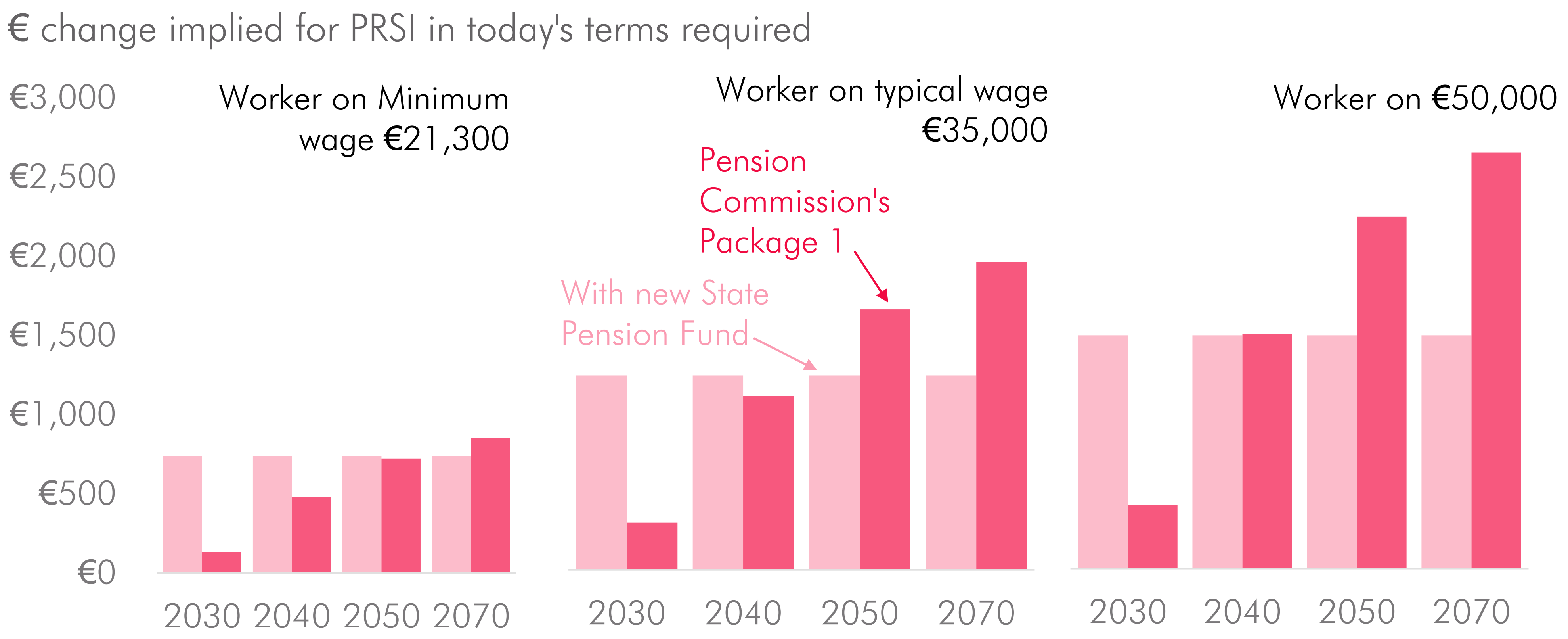
A. Reserves of the pension fund

% GNI*



Sources: Authors workings.

Baseline results: Impact on workers (labour costs)



Sources: Pension Commission (2021); and Authors workings.
Notes: Figure shows only the required increase in PRSI payments from increasing only the employees' rate and the higher employer's rate under the pension fund proposal here, and the Pension Commission's package 1.

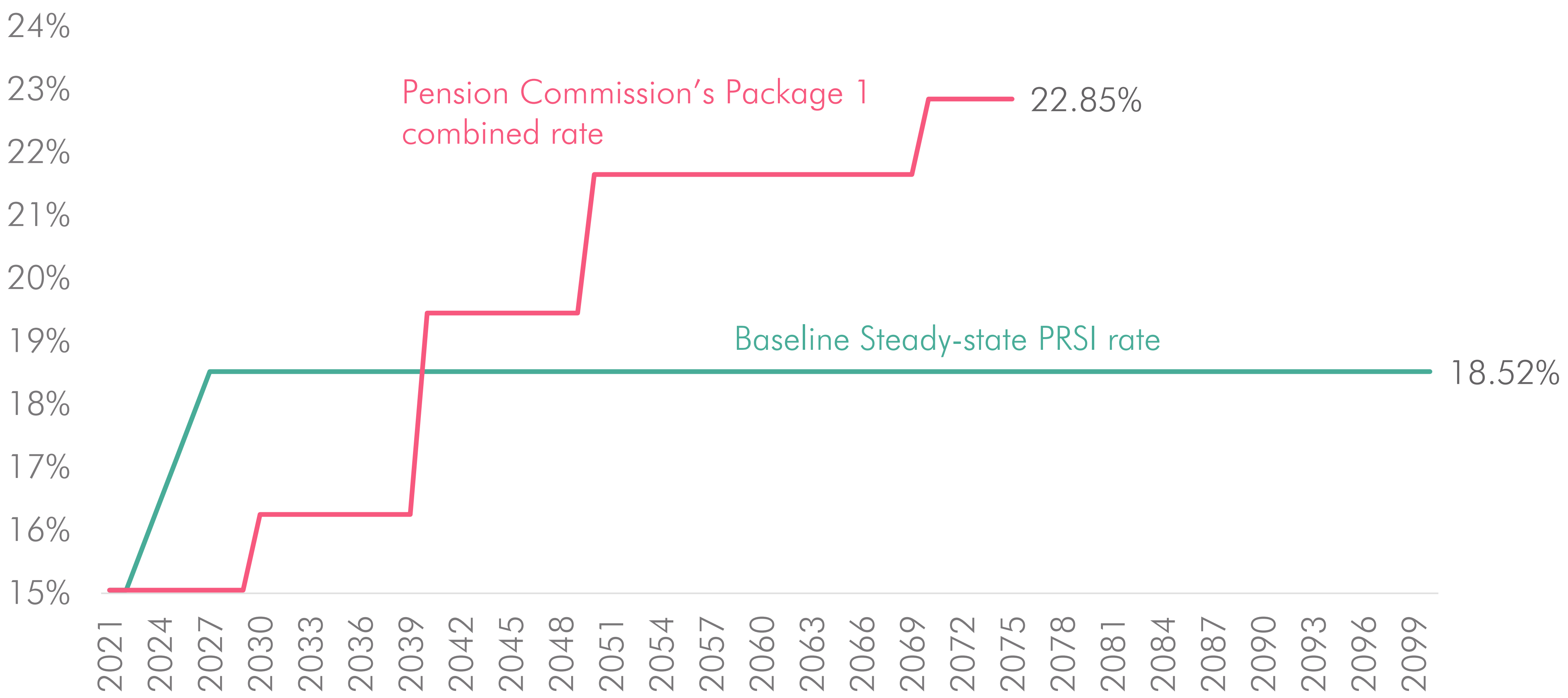
Scenarios and sensitivity analysis

Increasing the State pension age in line with Pension Commission proposals

- One way of lowering the future costs of the State pension is by increasing the State pension age.
- Two of the Pension Commission’s options included increasing the State Pension age.
- Starting in 2027, the Pension Commission’s proposed increasing the State Pension age by 3 months every year, reaching 67 by 2031.
- Then the State Pension age would increase by 3 months every two-years, reaching 68 by 2039.

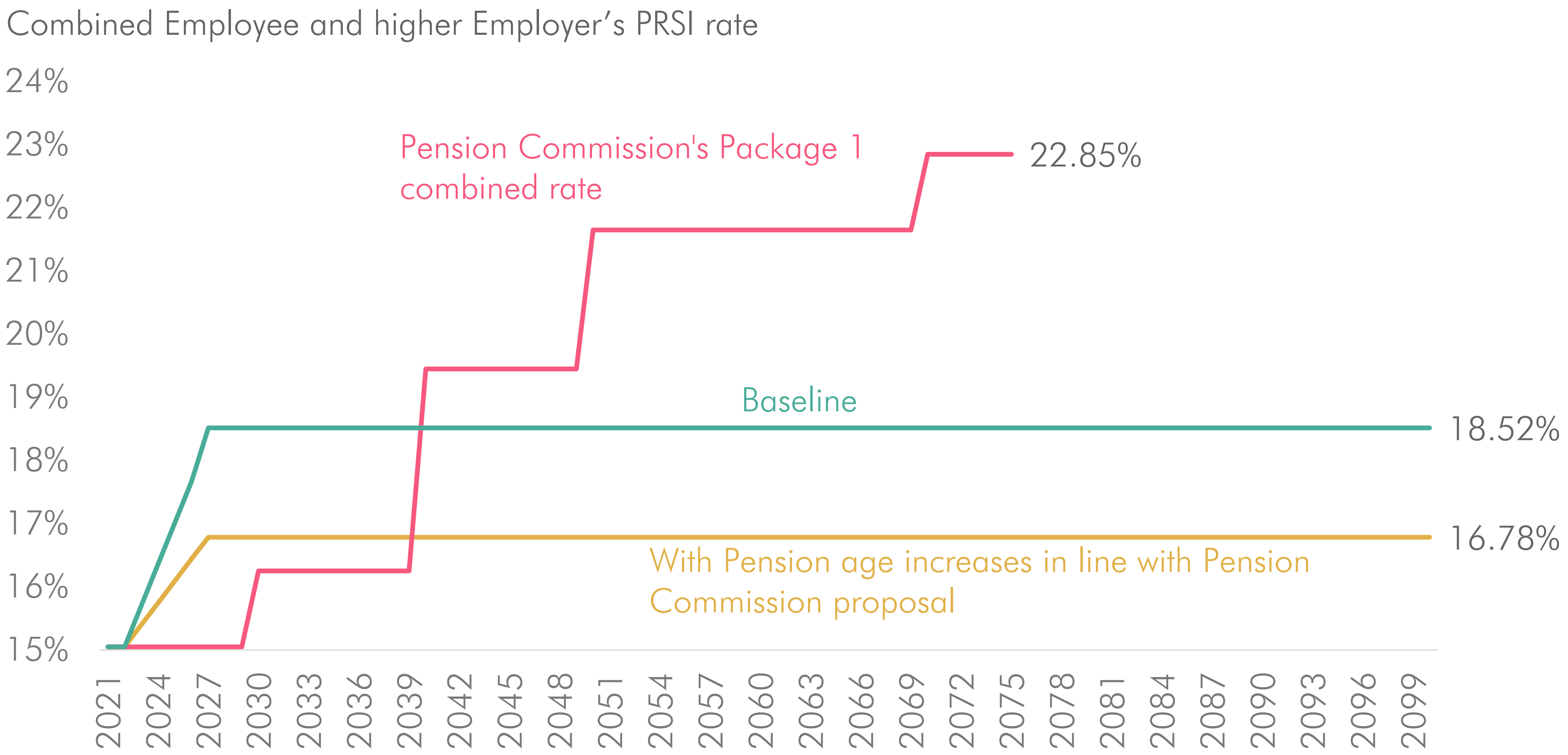
Increasing the State pension age in line with Pension Commission proposals

Combined Employee and higher Employer's PRSI rate



Sources: Pension Commission (2021); and Authors workings.

Increasing the State pension age in line with Pension Commission proposals



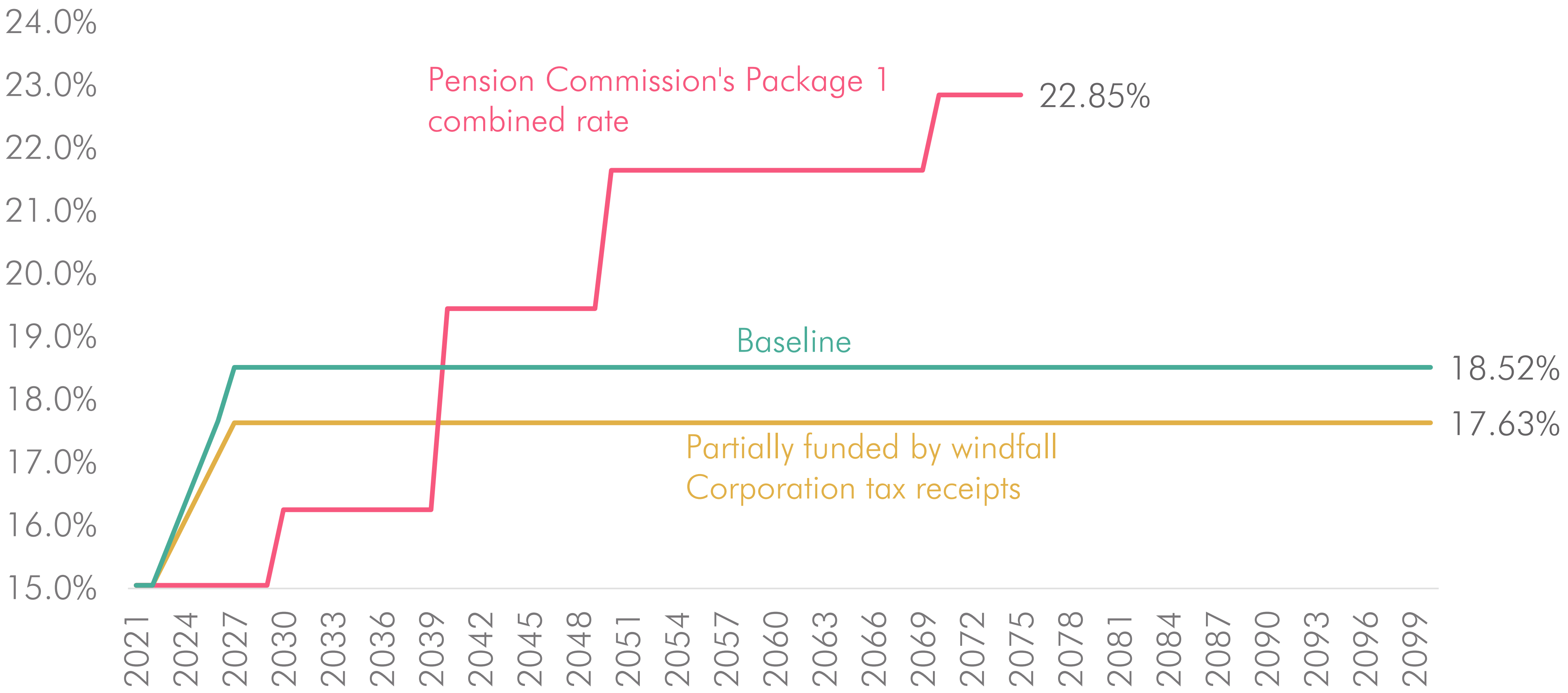
Sources: Pension Commission (2021); and Authors workings.

Using windfall corporation tax receipts to pre-fund pensions

- The Department of Finance estimate windfall receipts of €10 billion in 2023, €9 billion in 2024, and €9.5 billion in 2025.
- In this scenario, we assume €2 billion currently in the National Reserve fund gets transferred to the State Pension Fund in 2023
- We then assume that all windfall Corporation tax receipts between 2023-2025 are transferred to the Fund. We assume no more windfall Corporation tax receipts thereafter.
- In total, €30.5 billion gets transferred to the fund

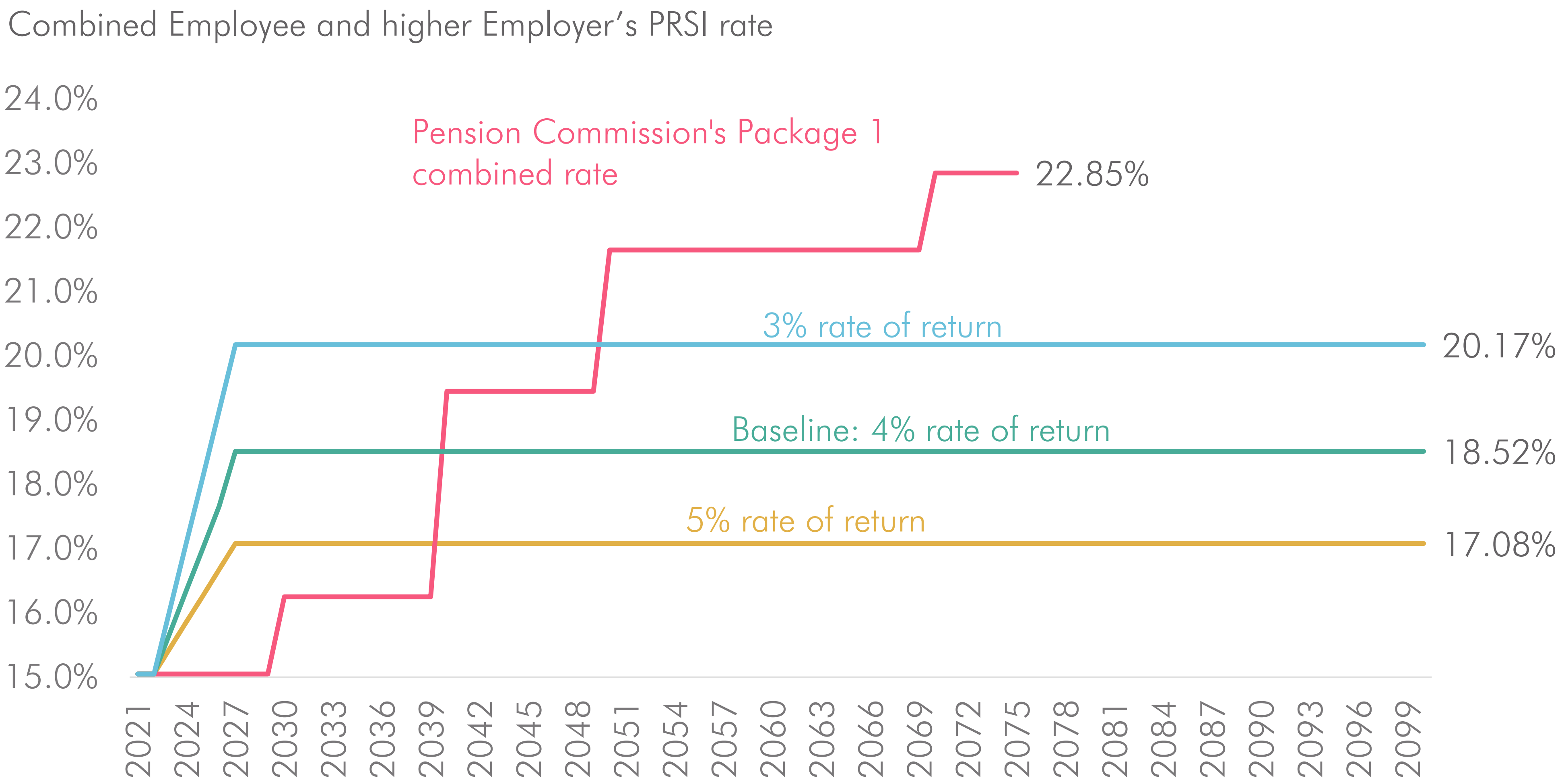
Using windfall corporation tax receipts

Combined Employee and higher Employer's PRSI rate



Sources: Pension Commission (2021); and Authors workings.

Different nominal rates of return on assets



Sources: Pension Commission (2021); and Authors workings.

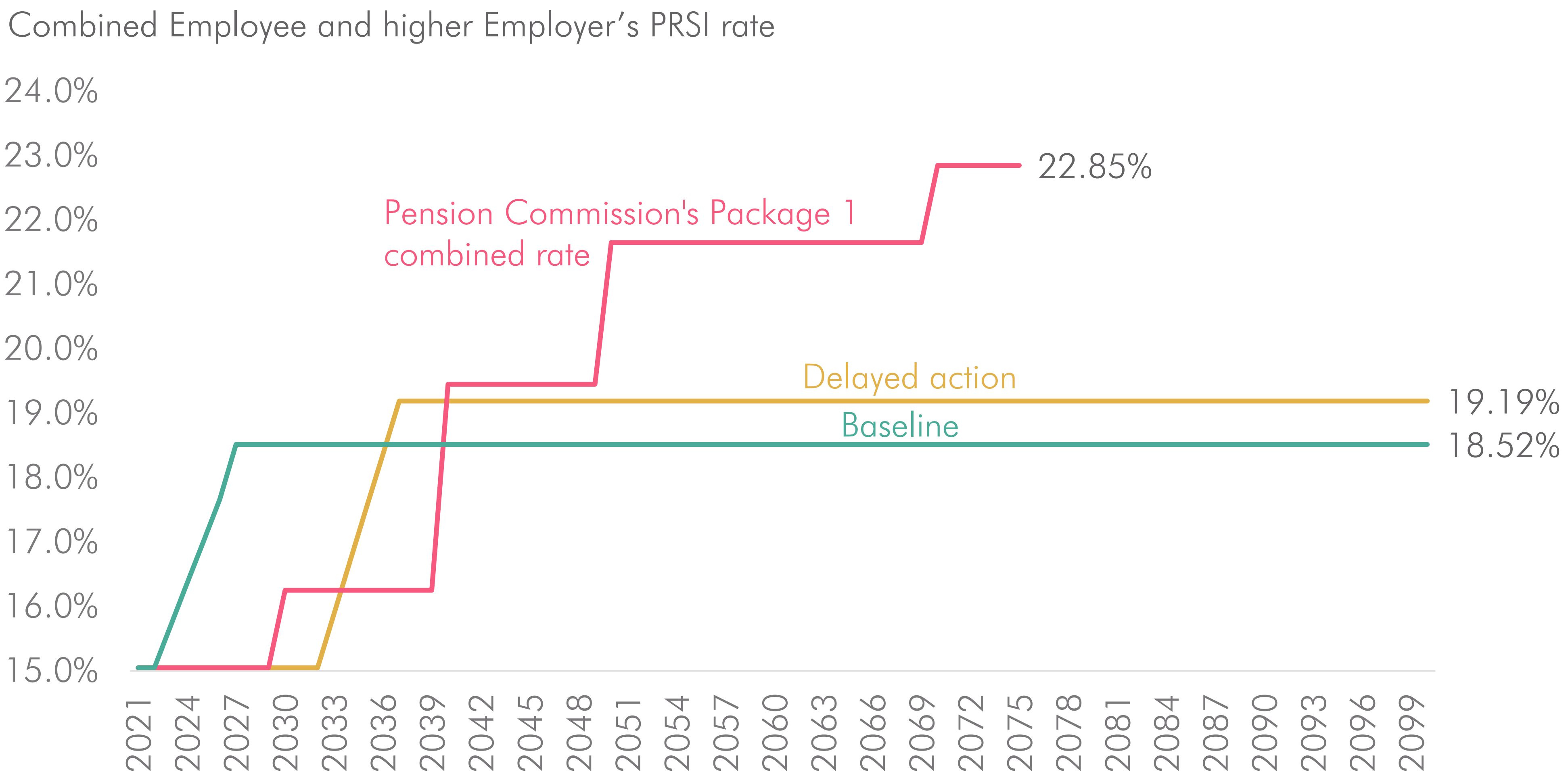
Delayed action

- In this scenario, we assume that PRSI increases do not now take place until 2033.

- Like in the baseline, increases are staggered until 2037.

- The steady-state PRSI rate is set so that the Asset/Expenditure ratio in year 15 (2048 in this case), is equal to the Asset/Expenditure ratio in year 65 (2098 in this case)

Effect of delaying action on increasing PRSI



Sources: Pension Commission (2021); and Authors workings.

Summary

- Ireland's population is ageing rapidly. This puts increasing pressure on the State pension
- This requires a long-term approach to managing and funding the pension system
- One approach: create a separate State Pension Fund to support the State Pension and fund this through a steady-state PRSI rate
- This approach can lead to substantially lower PRSI rates over the long-term, than would otherwise be the case

Thank you

www.FiscalCouncil.ie