Completing Australia's retirement income system

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Introduction

The Retirement Income Review (the Review) whose report was released in December 2020 provides a most useful evidence base for consideration of any further reform of Australia's unique retirement income system. Its terms of reference did not allow the Review to make recommendations but its analysis provides considerable guidance suggesting in particular that the system which is now beginning to mature is 'effective, sound and its costs are broadly sustainable' implying that, while some refinements might be advisable, radical changes to the system are not warranted (Callaghan, Ralston, and Kay 2020).

The Academy of the Social Sciences in Australia (ASSA) and the Australian National University's (ANU) Tax and Transfer Policy Institute (TTPI) hosted a roundtable in March 2021 to examine the Review's report and to consider its implications for further reform of the system (Podger 2020). The roundtable had around 30 invited participants from academia, government and industry, all with expertise in the field. It was conducted under the Chatham House Rule to promote full and frank discussion, and to allow dissemination of information from the roundtable so long as any references to individual contributions have the individual's clear permission. There was no attempt to obtain any endorsed policy position by roundtable participants.

This paper draws heavily on the roundtable presentations and discussions. However, it represents the authors' views on future reforms which other participants may or may not agree with. It also draws on some subsequent discussions with some of the roundtable presenters to clarify some of the issues raised. The presentations made are attached, some updated since the roundtable, with the permission of the presenters.

John Piggott opened the roundtable suggesting discussion first explore the objective of the retirement income system. In his presentation (Attachment A), he highlighted four key messages from the Review: that we have a basically good system that broadly meets its objective; the need for more careful consideration of risks and risk management; that more attention needs to be given to drawdown arrangements following retirement; and the importance of housing. In exploring these messages, he suggested the roundtable look closely at what he considered weaknesses in the Review's report: the limited references to the impact of the system on efficiency including with regard to tax arrangements, the suggestion that people are misperceiving and exaggerating risks (particularly concerning possible future policy changes), and the underestimation of the reduction in poverty from increasing Commonwealth rent assistance.

The system's objective

The Review suggested that the objective of the overall retirement income system be developed around the following goal:

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> ‘to deliver adequate standards of living in retirement in an equitable, sustainable and cohesive way’ (Callaghan, Ralston, and Kay 2020).

It suggested that what constitutes ‘adequate, equitable, sustainable and coherent’ should be made clear and preferably legislated, presenting its own suggestions for each of these key elements:

- Adequacy requiring the system both to ensure a minimum income consistent with prevailing community standards and to facilitate people to reasonably maintain their standard of living in retirement;
- Equity so the system targets Government support to those in need and provides similar outcomes for people in similar circumstances;
- Sustainability meaning the system should be cost-effective in achieving adequate retirement incomes and robust to demographic, economic and social change; and
- Cohesion meaning the system has effective incentives to smooth consumption and support people in taking personal responsibility, interacts effectively with other systems and is not unnecessarily complex for consumers.

A system-wide objective would indeed be helpful, facilitating better public understanding of how the different pillars of the system should work together towards a common purpose. The earlier recommendation by the Financial Services Inquiry for an objective for the superannuation pillar only, suggesting that it ‘supplement or replace the age pension’ (Murray et al. 2014), only begged the question of how it should do so and what the overall retirement income system should achieve.

While the four elements of the Review’s suggested objective make eminent sense, two other elements should also be considered: efficiency and security.

The system needs to be efficient in that it should facilitate the spreading of lifetime income and consumption and not penalise action to defer consumption to retirement. Similarly, it should not distort savings behaviour favouring some assets over others. It should also facilitate efficient risk management, such as the use of pooling to address longevity risk. The reference to ‘cost effective’ in the definition of ‘sustainability’ goes some way to address these efficiency issues, as does the reference to providing ‘similar outcomes for people in similar circumstances’ in the definition of ‘equity’. The following minor modification of the definition of ‘sustainability’ may therefore be sufficient to ensure efficiency of the system is properly covered:

- Sustainability meaning the system should be efficient and cost-effective in achieving adequate retirement incomes and robust to demographic, economic and social change.

Security, however, needs more explicit attention in the system’s objective. The Review arguably understates the issue of risk and the desire retirees have for security. Retirees’ concerns about risk are well justified. Apart from market, inflation and longevity risks that must be well managed, sovereign risk is real even if sometimes exaggerated as the Review suggests – how confident should retirees be about future government policies regarding the age pension, health insurance and aged care. In his presentation, Piggott highlighted for example how severely the Abbott Government's 2014 proposal to change the pension indexation arrangements would have affected pension entitlements 47 years later (Klapdor 2014). As suggested further below, consideration should be given to strengthening certainty about government policies in these areas but, even with such measures, it may be reasonable for people to expect the retirement income system will offer some protection for such uncertainties as well as for market, inflation and longevity risk.

More emphasis on security might also usefully point the system more towards regular income streams, better resembling other countries' defined benefits arrangements while retaining the strengths – particularly in terms of sustainability - of our system's reliance on defined contributions.

Our preference, therefore, would be a system objective along the following lines:

> 'to deliver secure and adequate standards of living in retirement for all Australians in an equitable, sustainable and cohesive way.'

What constitutes 'security' might be described as:

- Security requiring the system to provide adequate incomes throughout retirement years, offering reasonable protection from the risks of inflation, market variations, time of death and changes in government policy.

Performance of the system against this objective

The Review's conclusion that the system is 'effective, sound and its costs are broadly sustainable' is well supported by its analysis. In some respects, however, the conclusion relates to the system's potential when it is fully mature and the outstanding policy issues are settled rather than what it delivers at present. There are aspects of the Review's analysis that warrant more careful assessment.

In summary:

- Adequacy: there are questions about the Review's modelling which led to its conclusion that the (then) current 9.5% Superannuation Guarantee (SG) would deliver more than the Review's benchmark of adequacy for a person or couple with median earnings (65-75% of pre-retirement income);
- Security: the security of retirement incomes is dependent upon the nature of the products people access from their accumulated savings, and on the degree to which people may reasonably depend on Government policies with respect to the age pension, Medicare and aged care in particular;
- Equity: there remain deficiencies in the safety net provided by the age pension, and people with similar total resources are not always treated equally;
- Sustainability: if anything, the system involves lower long-term costs than the Review's positive assessment indicates as its analysis arguably overstates the cost of the current tax treatment of superannuation;
- Cohesion: this remains the system's most significant weakness at present, particularly in the pensions phase, as the relationship between superannuation and the age pension is unduly complex and may not provide appropriate incentives for consumption smoothing and self-support, and insufficient consideration has yet been given to the system's relationship with aged care.

These matters are explored in the following sections.

Modelling the adequacy of the system

The Review's adequacy benchmark of 65-75% net income replacement rate for a person or couple with median earnings is consistent with international practice. A lower benchmark ratio may be appropriate for those with high levels of earnings. The focus on median earners is also consistent with past Government statements about the policy objective of superannuation and the role of the (compulsory) SG, noting the greater capacity of those with higher earnings to supplement their

savings beyond the SG (Swoboda 2017). The Review's assumption that its adequacy benchmark for income maintenance relates to retirees owning their own home is also consistent with past Government policy statements, though it is also the case (as the Review notes) that home owners could draw on that asset for some of their retirement consumption needs.

The Review's modelling calculated the superannuation savings median earners are likely to accumulate after 40 years (with the current SG of 9.5%) and the income this plus any age pension entitlement could generate from age 67. The Review emphasised the challenges involved in making assumptions over such long periods and the significant impact the assumptions can have.

On the basis of the assumptions made, and using illustrative cameos of individual employment profiles, the Review concluded that a net income replacement rate as high as 84% might be achieved by a median earner with the existing 9.5% SG.

Matthew Linden and Bruce Bastian from Industry Super Australia provided the Roundtable with their analysis of the Review's modelling (see Attachment B for an updated version of their analysis). Key points raised were:

- The Review included (average) salary sacrifice contributions beyond the SG for all ages and income cohorts, despite evidence that most individuals do not make additional voluntary contributions and there are significant differences between those that do and those that don't:
    - Excluding these would reduce the replacement rate by around 5 percentage points.
- The Review assumed continuous 40-year working lives with SG contributions in all years for all income cohorts and both genders which is not consistent with HILDA longitudinal data:
    - Using more realistic profiles of working, SG coverage and coupling would reduce the replacement rate by around 10 percentage points.
- The Review assumes accumulated savings are drawn down in such a way as to fully compensate the real increases in age pension that the median person might be eligible for – that is, the total of superannuation income and age pension is indexed to prices, the former therefore delivering falling real income over time:
    - Indexing superannuation income by the CPI while indexing age pensions by wages would reduce the replacement rate by around 8 percentage points.
- The Review did not allow for any repayment of debt and optimised drawdown of gross assets to zero by average life expectancy which ignores observed behaviour and precautionary use of savings for emergencies, aged care and funerals:
    - Assuming a 10% drawdown (or minimum drawdown rates if higher) to allow some provision for precautionary use would reduce the replacement rate by around 3 percentage points.

Together, the ISA assumptions would reduce the Review's assessment of a median earner's replacement rate to under 60%, below the benchmark. The ISA also advise that the data bases of its members support the assumptions it suggests (Industry Super Australia 2021).

On the other hand, the Grattan Institute has published evidence that expenditure usually falls in real terms over retirement years, questioning the need for superannuation income to be indexed to prices if the retiree is eligible for some age pension which will increase in real terms . The Grattan research has also highlighted that financial stress is more commonly experienced amongst working age families and individuals than amongst retirees, raising questions about the case for increasing compulsory superannuation contributions in order to finance improved retirement incomes (Daley

et al. 2018). It is also possible, as mentioned, for retirees with housing assets to draw on these for retirement consumption needs without the need to increase superannuation savings to be able to maintain living standards.

What emerges from this is that it is not possible to conclude with certainty that adequacy in terms of income maintenance will be achieved with the current 9.5% SG or whether increasing it to 12% as legislated is still necessary. Two factors in particular contribute to this uncertainty.

- First, it is not yet clear what post-retirement products funds should be offering to members that would be in the members' best interests and most likely to address their (informed) preferences. The Review's ('optimal') product for its modelling is not one the funds could offer in practice.
- Secondly, the current means test arrangements, particularly the assets test taper, have a significant impact on the calculation of the level of accumulated superannuation which, with some age pension, would meet the adequacy benchmark. Quite large differences in levels of assets lead to only small differences (if any) in net retirement income.

While not fully explored at the roundtable, as discussed below, addressing these two issues is a prerequisite for determining the appropriate level of the SG to ensure the system achieves adequate retirement incomes. They relate in particular to the system's effectiveness in delivering secure as well as adequate incomes and in meeting the requirement for cohesion. The Government's 2021-22 Budget has left untouched the legislated increase in the SG to 12%. Accordingly, the SG increased to 10% in July this year though it is possible that further increases, while legislated, will be subject to reassessment after the next election.

The roundtable did not directly explore the adequacy of superannuation for women and the substantial gap between the balances held by men and those held by women. As the Review noted, this gap is primarily driven by the differences in the employment and earnings profiles of women and men though some aspects of the SG system do exacerbate those differences (e.g. the $450 threshold before the SG is applied and the failure to require SG contributions from parental pay). The gap is also sometimes overstated as the right which women have to share their partners' superannuation (and the common practice of doing so) is not generally included in the comparative data.

The 2021-22 Budget announced some modest action to address the inequality but a sizeable gap is almost certain to continue unless and until women's employment and wages become more similar to those of men.

Superannuation products that ensure secure and adequate retirement incomes

International practice regarding post-retirement superannuation products is dominated by lifetime annuities (see David Knox's presentation at Attachment C). But this is usually related to their systems' historic social insurance design with defined benefits rather than defined contributions. Where systems now include defined contributions schemes (usually supplementing social insurance), those schemes' post-retirement products are not so dominated by lifetime annuities. Australia, with its unique emphasis on defined contributions, will need to find its own way to decide on the optimal products in retirement.

Current practice in Australia is not a useful guide either. Hazel Bateman in her presentation to the workshop (see Attachment D) reveals that an account-based pension based on the minimum drawdown rate is currently the 'effective default', that the menu of products offered by funds is

short and that retirees are not well-informed about the alternatives. Current behaviour reflects a great deal of ‘precautionary savings’ to self-insure against perceived risks including health, aged care and other shocks as well as longevity risk. She also reveals from surveys that intended bequests are not a high priority for most retirees, suggesting that the significant bequests arising from current use of superannuation savings reflect sub-optimal use.

Bateman also referred to her earlier research (Iskhakov, Thorp, and Bateman 2015) which investigated the optimal use of superannuation savings in the Australian context with a means-tested age pension, both to maintain living standards and to address risks (longevity, market, inflation and other contingencies). This suggested a mix of life annuity, investment account and access to liquidity, the mix varying with personal circumstances, particularly the likelihood of eligibility for the age pension. For lower income retirees, the age pension provides considerable protection from longevity, market and inflation risk, reducing the proportion of superannuation savings that should (optimally) be directed to life annuities. Broadly, the optimal product for those likely to be eligible for a part pension was found to include around 25% directed to a life annuity and for those unlikely to be eligible for any age pension was found to include around 40% directed to a life annuity. The precise optimal mix depends on other personal factors including wealth, attitudes to risk, concern to maintain a particular consumption floor, gender, whether single or couple, home ownership and health status.

What is clear from Bateman’s work is the importance of the Government facilitating confidence in how retirees drawdown their superannuation savings. A public information campaign should include regular information to those over 50 ahead of their retirement. It is important to help people frame their superannuation savings in terms of the income those savings will provide. The Review’s suggestion of requiring the funds to present their members with information on the incomes their savings are likely to generate in retirement, as well as on their current accumulation, is an important component. Access to models that estimate age pension entitlement would also assist (but see further below on cohesion and the means test).

The Government’s planned covenant for fund trustees is also critical. To be introduced in 2022, this will require the funds to act in the best interests of retiree members including by offering default products likely to do so for members uncertain about what would best suit their circumstances. Up to three ‘flagship’ products are to be offered according to the Government’s 2018 Position Paper, most likely linked to whether the retiree will rely heavily on the age pension, less heavily on the pension or not at all (Australian Treasury 2018).

This approach is a variation on the Financial System Inquiry’s suggested Comprehensive Income Product for Retirement (CIPR) that funds should be required to offer (Murray et al. 2014). There may still be room under the covenant approach for funds to identify a wider range (but still a short menu) of ‘smart defaults’ that are related to the retired member’s super balance, whether single or partnered, whether a home owner or not, etc.

Consistent with Bateman’s analysis, David Knox included an example of a default product in his presentation for a single person likely to be eligible for a part age pension. This default involves a mix of 25% for longevity protection, 50% in an account based pension with minimum and maximum drawdowns and 25% for capital access (whether for discretionary spending or for precautionary savings). Knox raises, but does not answer, some ‘unresolved issues’ relating to such a product, including:

- The appropriate indexation arrangements: while identifying the option of wages indexation, the evidence on retirees' expenditure patterns and needs points to price indexation or something lower. For those concerned to maintain a consumption floor, a significant part of the product (if not the total) should be indexed to prices for inflation protection. This could be achieved by a combination of a CPI-indexed life annuity and appropriate drawdowns from the account based pension. For those likely to be eligible for some age pension, that entitlement will increase with wages (or faster as accumulated savings run down), suggesting superannuation drawdowns that are not fully indexed to prices (but starting higher as the Review suggests).
- Early retirement arrangements: as most people retire before the age pension eligibility age, consideration must be given to the product arrangements before any such eligibility as well as after. The gap between preservation age and age pension age is now 7 years, arguably too wide for simple designs of default products.
- The role of the age pension: as discussed below, it is important to clarify the extent to which people can plan on the basis of prevailing age pension parameters – indexation, means test rules etc. This is essential for both trustees in designing 'flagship' or 'smart default' products and retirees in making their choices. Similarly, it would assist if retirees could be more confident of other government support arrangements including with regard to Medicare and health insurance and aged care.

While life annuities may be only part of the mix for retirees' optimal use of their retirement savings, for the majority it is likely to be an important component. One concern about such annuities is whether, in responding to longevity risk via some form of life annuity, retirees may find the market risk exacerbated – in particular, that the price of such annuities when interest rates are low will be unduly high given prudential requirements. Funds now offering different forms of such annuities claim, however, that the market risk might not be as great as feared and that there may be ways of managing the risk. Challenger is currently offering non-indexed life annuities (with no reversionary benefit) of around 8% of the capital price for a single person aged 67, and CPI-indexed annuities of around 5.5% (Challenger 2021); QSuper (QSuper 2021) and Mercer (Mercer 2021) are offering group annuity products where there is flexibility to vary the payment each year based around the group earnings so as to spread the market risk over both years and the group.

Nonetheless, there remains a case for the Government to sell annuities, accepting (at a suitable price) both longevity and market risk (and inflation risk). The existing pensioner loan scheme discussed further below represents one way of doing so.

In summary, further work is necessary if the system is to meet the objective of security and adequacy with the most efficient use of superannuation savings. Retirees may not want to have their choices too constrained but most are seeking direction and do not feel confident about the decisions they need to make. This is consistent with other research showing most people are 'passive' savers relying heavily on default arrangements or other regulated guidance (Varela, Breunig and Sobeck 2020). Constraining the funds (but not their members) via the proposed covenant, requiring regular advice on the incomes accumulated savings are likely to deliver and promoting the offering of smart defaults will go a long way towards ensuring the system delivers on its potential. It seems most unlikely that the default products the funds will offer (consistent with the covenant) will look like the 'optimal' product used by the Review in its modelling, but the Review's suggestions of higher early drawdowns than are currently common practice combined with some form of life annuity may well apply for most retirees, the precise mix varying with their likely entitlement to some age pension.

Cohesion between superannuation and the age pension

The Review rightly highlights the importance of cohesion if the Australian system is to meet its objective. Unlike most overseas social insurance schemes where most retirees receive income from just one social insurance scheme (a small minority being eligible for social assistance), the Australian system involves a majority receiving income from both superannuation and the means-tested age pension. While the proportion of those of age pension age eligible for some pension is falling as superannuation balances are increasing, over 70% currently receive some pension and, depending on future means test arrangements, it seems likely this proportion will not fall further than to around 60% when the system matures. The proportion receiving the full pension is falling, perhaps to around 30% in future, while the proportion eligible for a part age pension seems likely to remain around 30%. (The 2021 Intergenerational Report projects around 25% on full pension, 35% on part pension and 40% on no pension in 2061 based on current policies (Australian Treasury 2021)).

With such an overlap of the key pillars of the Australian system (superannuation and the age pension), it is essential for people to understand how they interact and to be able to plan their retirement savings accordingly. The interaction should also, as the Review suggests, provide appropriate incentives for consumption smoothing and taking personal responsibility.

The key challenge in designing means tests is to get the balance right between concentrating assistance on those most in need and providing reasonable rewards for self-help via work or saving. The importance of a reward for self-help might not be significant if only a few people were eligible for the pension; in that case, relaxing the means test to offer eligible people a reward for self-help might greatly increase the numbers of people eligible and hence the total number subject to the means test's taper That is not the case in the Australian system where the majority of the aged are, and are expected in the future to be, eligible for a full or part pension. Ensuring a reasonable reward is therefore important to the design of the pension means test in Australia.

Moreover, this balancing is not just about incentives. Where extra saving is mandated, there is a right to expect commensurate improvements in retirement income. Otherwise, in such cases, the SG can only be considered a tax.

The appropriate effective marginal tax rate set by the means test is nonetheless a matter for judgement though it does need to be substantially lower than 100%.

Another less appreciated trade-off has been highlighted in work by George Kudrna (Kudrna 2015). The costs associated with any relaxing of the means test would need to be met, presumably by taxing workers through increasing their marginal tax rates. The efficiency costs of such higher marginal tax rates for workers need to be balanced against the efficiency gains from reducing the high effective marginal tax rates amongst retirees, taking into account that retirees have more limited choices over working and saving. This suggests, perhaps, that effective marginal tax rates for retirees of the order of 50% to 60% would not be excessive despite being higher than the rates workers generally face; such rates might also allow reasonable rewards for saving for retirement.

The Review examined the current means test arrangements and, while acknowledging Australia's unique practice of separate income and assets tests which contributes to different treatment of people with similar total resources, it suggested the current assets test taper (reducing pensions by $3 per fortnight for each $1,000 of assessable assets above certain thresholds) could still leave the affected retirees with some improvement in their retirement income from extra savings. On its assessment, the increase for those affected by the taper would be about one third of the reduction in income while working from any additional savings. This assumes the retiree draws down their

savings quickly to maximise pension entitlement at older years and does not direct savings into life annuities or hold them for precautionary purposes: the improvement in retirement would almost certainly be a lower proportion of the reduction in income while working if the savings were deployed in accordance with the likely default products offered by funds under the proposed covenant. These ratios of benefits to costs are significantly lower than those arising from the income test which has a taper of 50% above its 'free areas'.

Andrew Podger presented the case for a merged means test (Attachment E), ensuring more consistent treatment of income and assessable assets by focussing on the income in retirement that the assets may reasonably be expected to offer. The merging of the two tests would also effectively reduce the current assets test taper.

While the Review presented an example of a merged means test, it was highly complicated with the conversion rate of assets to income varying with age. Drawing on the merged means test that operated in the 1960s, Podger suggested a standard conversion rate of assets into equivalent income. In the 1960s, the conversion rate of 10% was based on the price of a CPI-indexed annuity at age 65: now, such an annuity at age 67 would be around 6 -6.5%. If the annuity were not indexed it would be 8% or slightly higher, and if purchased at an older age a larger annuity could be purchased.

Podger suggested a single conversion factor of around 8%; it would not need to be varied with changes in interest rates (which occurs now with deeming arrangements under the income test). Having converted assets into equivalent income this way and then applying the 50% income test taper, the effective assets taper under this merged means test would be 4% or similar to the 3.9% taper that applied under the assets test before 2017.

Under such a merged means test, those who buy a life annuity would have the non-commutable component subject solely to the income test; for deferred annuities that would only occur at the time it was paid. This would provide a clear incentive to purchase life annuities.

Podger suggested that, with this relaxed effective taper, the assets test thresholds could be lower than the ones introduced in 2017: he suggested thresholds of around $100,000 for home owners and $350,000 for non-home owners.

It would also be possible, consistent with Kudrna's analysis, to vary slightly the income test taper under such a merged means test (e.g. to increase it to 60%) if it was considered necessary to contain the cost of the change and to limit benefits to those with substantial assets, without undermining the overall benefits of the merged means test.

Podger also suggested the Government provide greater certainty about future age pension arrangements not only confirming that pension rates will continue to be indexed to wages but that the means test thresholds also be indexed to wages (e.g. by setting the income test free areas at 25% of the pension) and that the assets-to-income conversion rate and the income test taper be fixed.

Jeremy Cooper in his presentation (see Attachment F) highlighted the scale of superannuation balances already in the pensions phase and the impact on age pension eligibility particularly on younger retirees. While acknowledging there are problems with the current means test, he was not persuaded of the need to reduce the assets test taper, noting that someone with $1 million in superannuation is always in a better position than someone with $400,000. The income from the savings may not consistently exceed 7.8% (the current assets test taper) but retirees can and should

be drawing down their capital. Accordingly, he questioned 'effective marginal tax rate thinking' and concerns about incentives.

While the appropriate effective marginal tax rate is open to legitimate debate and there was no firm agreement at the roundtable, the issues about incentives and appropriately balancing the cost of saving during working life and the net improvement in living standards in retirement are real and central to the system achieving its objectives including adequacy, equity and cohesion. Certainly there is an expectation that retirees can and should draw down the capital in their superannuation assets, but this does not mean that means test tapers are unimportant.

There would be considerable advantages in a merged means test along the lines proposed by Podger. It would be much simpler than the one identified (and criticised) in the Review's report. It would remove the inconsistencies between the current income and assets tests thus better meeting the equity objective of the retirement income system. It would set a better balance between the reduction in income from saving and the consequent improvement in retirement income and hence ensure more appropriate incentives to save. And it would encourage people to focus on the system's central role in providing secure income streams rather than to focus on the accumulated assets *per se.*

The advantages of simplicity and more appropriate incentives would also provide a better base for funds to design appropriate products for members and for those approaching retirement to make their plans with some confidence. While these advantages were widely acknowledged at the roundtable, some were not persuaded about the importance of simplicity. Jeremy Cooper suggested in his presentation that the complexities of the current rules could be built into an application people could have on their computer or smart phone allowing them to identify their pension entitlement and how that would be affected by the decisions they took without having to understand how the 'black box' itself works. It was noted, however, that this would still require the means test rules to produce outcomes that encouraged appropriate behaviour as people identified the impact of the different decisions they might make. There would also be a need for approval, presumably by APRA, of any app offered by the funds or financial advisers and of the assumptions it incorporated. Such assumptions would be made more reliable if the pension rules were less complicated and were set with greater certainty about their future.

Cohesion would also be improved if the difference between preservation age and age pension age were narrowed, reducing the need for retirees to allocate a significant component of their superannuation savings for support prior to gaining possible eligibility for the pension.

Adequacy for the vulnerable

The Review's definition of adequacy includes ensuring a minimum income consistent with community standards as well as maintenance of living standards in retirement.

Peter Whiteford in his presentation (see Attachment G) noted that Australia's safety net pension, the age pension, is above the OECD average as a proportion of average earnings, but highlights the two groups identified by the Review as having inadequate social security support: those renting privately and those forced to retire before age pension age.

The Review concluded that, even if the maximum rate of rent assistance was increased significantly, this assistance would remain a small proportion of the housing expenses faced by retiree renters and would not significantly alleviate stress and income poverty rates for retiree renters. The Review concluded that the current design of rent assistance has limited capacity to help retiree renters

achieve adequate retirement outcomes and a broader approach to supporting renters in retirement should be considered.

Whiteford's analysis, however, suggests that increasing rent assistance would be a highly target-efficient way of addressing the inadequacy of minimum income support for private renters: nearly 90% of rent assistance goes to the lowest wealth quartile of retired households (under 30% of the pension goes to this quartile).

Whiteford used the Review's figures to show that, while the proportion of retired households renting had not changed significantly, the share of those in public housing has steadily declined over the last decade or more causing more to be in private rental accommodation and hence vulnerable to inadequate support.

There is therefore a strong case not only for increasing rent assistance but also for changing the eligibility rules to more closely align the assistance to that available to public housing tenants, particularly if access to public housing continues to decline. This would be consistent with the recommendations of the Henry and Harmer Reviews more than a decade ago and proposals for housing reform canvassed by the Keating Government and COAG in the mid-1990s (Harmer 2009; Henry et al. 2010; Keating 1995; McIntosh 1997).

Whiteford revealed that a significant proportion (around 50%) of those going onto the age pension at age pension age are already long-term income support recipients. The majority had been in receipt of Newstart whose rate is significantly lower than the pension (and, despite the modest increase confirmed in the Budget will remain so). As the Review noted, increasing Newstart raises wider questions about appropriate incentives for unemployed people of all ages to work, but there is a strong case not only for a substantial increase for older people with limited opportunities to find work but also for indexing the payment with wages rather than prices to maintain its relativity with the pension. This would be consistent with the Henry Report recommendations.

A further option is to relax access to the disability support pension (which is paid at the age pension rate) for the very long-term older unemployed.

While few of those forced to retire early will have substantial superannuation savings, most in future are likely to have some, and many others choose to retire before age pension age. It will be important for funds to guide early retirees towards the most suitable use of their savings including how much to draw on before likely eligibility for the pension and how much to allocate towards supplementing the pension on reaching age pension age.

Equity and housing

In his presentation to the roundtable (see Attachment H), Bruce Bradbury notes that home ownership has long been regarded as one of the pillars of Australia's retirement income system. It limits the costs of shelter in old age, it is a store of wealth that can be used to meet contingencies and it provides security. For home owners, the age pension generally provides adequate protection from poverty.

Bradbury also notes that, while home ownership rates have been falling amongst younger age groups, they have remained high and relatively stable so far for those aged 65 and over. Whether the decline amongst younger cohorts will flow on to the aged, or whether they may 'catch up' later, is not yet clear. There is evidence, however, of more home owners aged 65 and over having mortgages, though this is still only 11% of the overall population of couples and 6% of singles. While

the cost of servicing the mortgages is unlikely to be high in most cases, there is evidence of some increase in poverty amongst owners with mortgages.

Consistent with Whiteford's analysis, Bradbury notes the high levels of poverty amongst those renting privately, the increase in the numbers involved (as public rental has diminished) and the very strong case for increasing rental assistance, possibly along the lines proposed in the Henry Report. In its research. The Grattan Institute also highlighted the importance of affordable housing for the retired (Grattan Institute 2020).

Bradbury also addresses the equity issue raised by the Review concerning the exemption of owner-occupied home assets under the pension means test which is also likely to distort savings behaviour. The assets test's higher threshold for renters over home-owners goes a small way towards equity though the $210,000 difference is less than the value of a typical home. While increasing this difference might further reduce the inequity between renters and home-owners, there is a strong in-principle case for including home assets in the means test.

Given that the exemption of the owner-occupied home has existed since age pensions were first introduced by the Commonwealth, such a change would be politically difficult. There would also be important design parameters to settle including whether some threshold value for the home should be exempt and if such a threshold should vary with location, or if only a general assets threshold should apply.

Such a shift could only be contemplated if those with substantial home assets could be confident of their ability to draw income from the assets without any loss of security to remain in their home. The pensioner loan scheme offers one means of drawing income from the home assets but to date it has not been widely used. Market-based reverse mortgages guaranteeing security of tenure and some floor asset value retention are also not widely available or used. Interest and confidence in such products may increase as superannuation funds provide more advice on retirement income products for retirees in different circumstances including whether they own their home and the value of the home.

Another factor to consider is the extent to which retirees who own their homes see that as offering security also for accessing residential aged care if required. It may be appropriate to explore whether and how home assets should be taken into account in the subsidisation of aged care before taking those assets into account under the pension means test. As canvassed briefly below, an important aspect of 'cohesion' in the retirement income system is the relationship between that system and aged care.

While common treatment of all assets under means tests would ensure greater equity, there are also differences in the tax treatment of different assets and savings, raising broader questions of equity and possible distortions beyond pensioners. Perhaps it would be fairer to address the broader issue first rather than focus only on the social security system. Relevant tax issues are considered further below.

Cohesion with other assistance for the aged

While achieving coherence between superannuation and the age pension is the most important aspect of cohesion, there is also a need for greater coherence between the retirement income system and the health and aged care systems. Retirees need reasonable confidence about how best to manage the risks to their health as they grow older.

The Review suggested many retirees underestimate the extent to which there is and will continue to be government assistance to address contingent requirements for expensive health or aged care and accordingly overestimate the capital funds they need to retain as a precaution. On the other hand, several roundtable participants noted the extent to which such government support is subject to changing rules about eligibility and coverage and that retirees justifiably want to be able to respond to this by maintaining some precautionary savings. The issue is how much is reasonable and how best to advise retirees about this.

At the time of the roundtable the Government was yet to respond to the final report of the Royal Commission on Aged Care. It has since done so in the context of the 2021-22 Budget. Government support will be considerably increased and further steps taken to give recipients of care more choice about the nature of the care and about where the care is provided and the level of their non-care living arrangements and services. This means retirees should be more confident of Government support for a reasonable minimum level of care. While no changes have been announced to the contributions recipients of aged care services are expected to make towards the costs involved, those requiring residential care will continue to be required to draw on their home assets (though the form of this may change); the continuing need to make contributions to living expenses may also suggest that most retirees should ensure their superannuation includes ongoing income streams in their very old age, particularly those wanting higher living standards than the basic standard offered.

Retirees might therefore be advised to limit the amount of capital kept in reserve for aged care contingencies relying mostly on the home assets for that purpose; they might also be advised to look to retirement income products that provide continuing adequate income streams in very old age.

Equity and taxation arrangements

The Review found that the age pension reduces income inequality among retirees and more than offsets the increased income inequality due to superannuation tax concessions; as the system matures, retirement incomes from the age pension and superannuation are expected to be more equally distributed. It also found that full-time, higher income and continuously employed people receive more lifetime Government support than lower and middle income earners as they make more superannuation contributions and receive more tax concessions.

These findings are based on the Review's definition of the superannuation concessions: the current departure from treating superannuation contributions and earnings as income in the hands of the individual at the time the contributions are made and the earnings accrue, with the income eventually received being exempt from tax (a TTE benchmark).

As several participants noted, a TTE approach would not in fact be neutral but would favour immediate consumption over postponed consumption, penalising savings. Measuring tax 'concessions' against such a benchmark not only affects the quantum of the 'concessions' but also their distribution, the 'concessions' increasing significantly with the contributions made and the earnings accruing. While superannuation contributions do reduce government revenue by reducing the income that would otherwise be taxed at the individual's marginal tax rate (compared to the 15% rate that applies to most contributions), this does not necessarily mean that a concession is involved.

The TTPI has long suggested that savings be subject to a separate, common taxation regime based largely on an expenditure tax concept (Varela, Breunig, and Sobeck 2020). Contributions would be subject to tax at individuals' marginal tax rates, perhaps with a small concession, but earnings would be subject, at most, to a very low standard tax rate (a TEE or TtE regime). A standard approach along

these lines might provide greater inter-temporal equity (removing biases for and against saving) and improve allocational efficiency (removing distortions between different forms of savings).

There is however a case for special treatment of superannuation. First, because the savings are held for very long periods, a particularly low or zero tax on earnings may be appropriate for inter-temporal equity. Second, much of the savings are compulsory and by law are not accessible until preservation age. This reflects the view that the state must intervene because public myopia would otherwise lead to inadequate savings for retirement and excessive reliance on the age pension. Such compulsion adds in particular to the case for not taxing the earnings from contributions. Third, arguably it would be more appropriate to apply any tax when the funds become available, not when they are first directed into superannuation or as they accrue through fund earnings. Finally, the premise behind superannuation is that it spreads lifetime earnings and the tax regime should reflect that – not taxing at the marginal rates when the income is earned but at the marginal (and average) rates when the savings are consumed. A similar principle is widely accepted when applied to farmers facing fluctuating incomes.

These considerations suggest the appropriate benchmark is EET, exempting both contributions and earnings and taxing benefits when received, at least with respect to superannuation savings below some caps (as is now the case).

Research by Phil Gallagher (Gallagher 2012) suggests that the current tax regime, since the introduction of some progressivity in the taxing of contributions under the Turnbull Government, has a similar outcome at least at median income levels to that of an EET regime despite its ttE design. Accordingly, it is arguable that there are few if any tax 'concessions' at present and no significant skewing to those on higher incomes.

On the other hand, as the Review identified, the large superannuation balances built up under previous generous contributions caps are expected to remain in the system for several decades: these did receive concessional tax treatment and the earnings continue to be subject to lower tax than income from other savings. Jeremy Cooper in his presentation highlighted the scale of such savings that remain in the system. It would be difficult however to now claw back the concessions however unfair they were at the time.

While the current tax regime for superannuation is complex it would now be hard to replace it directly with an EET regime and arguably inappropriate to replace it with a TEE or TtE regime. A more appropriate focus might be:

- To consider minor modifications to increase the progressivity of the tax on contributions consistent with the personal income tax scale;
- To apply an earnings tax in the pensions phase as well as the accumulation phase but perhaps at a lower rate (e,g. 10% rather than 15%);
- To introduce a modest estate duty on all savings in estates not transferred to a spouse or partner (including unused superannuation).

Conclusion

While there was no attempt to find a consensus at the roundtable, participants generally agreed with the Review's conclusion that the Australian retirement income system is 'effective, sound and its costs are broadly sustainable. We also detected broad agreement including with the Review on some directions for further reform that would help to ensure the Australian system does indeed meet its objective:

- The emphasis for further reform should now focus much more on the pensions phase rather than on the accumulation phase;
- The system needs to be presented more in terms of incomes than accumulated savings;
- More needs to be done to promote cohesion, particularly between superannuation, the age pension and the aged care system;
- There remain gaps in the safety net provided by the age pension;
- There is a strong case in principle for more consistent treatment of savings and assets for tax and means test purposes.

Our own priorities for reform in the short term are:

- To legislate the objective of the retirement income system building security into the formulation (adequacy, equity, cohesion and sustainability) proposed by the Review;
- Measures requiring funds to present members' current and expected accumulated savings in the form of the retirement income they can be expected to fund;
- Finalisation of the proposed covenant requiring funds to offer default products the trustees consider to be in the retired members' best interests;
- A merged means test which converts assets into equivalent retirement income streams and offers a more appropriate balancing of costs from saving while working and net benefits when retired (and more appropriate incentives);
- Increased rent assistance and increased Newstart, at least for older unemployed people.

Such an agenda would then allow reassessment of the most appropriate rate of the SG. We do not believe it possible to determine the appropriate rate with confidence until several of these matters are settled, but suspect the appropriate rate will lie between 10 and 12%.

Further reforms that should be seriously pursued include:

- More consistent taxing of savings even if it is accepted (as we do) that superannuation warrants slightly different treatment;
- The inclusion, with appropriate thresholds, of owner occupied housing in the pension means test (a start might be made by more explicit inclusion of the home in the aged care means test arrangements);
- A modest estate duty.

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Some thoughts on the Retirement Income Review

John Piggott

Objective of the system

- ‘*To deliver adequate standards of living in retirement in an equitable, sustainable and cohesive way*’.
- But SMSFs have a different objective. May change how we view the system

Criteria for evaluating the system

- Adequacy, equity, sustainability and cohesion
- But efficiency not on the list (some aspects captured under cohesion)

Important messages (high level)

- Good
- Misperception of risk (Myths)
- Draw down
- Housing

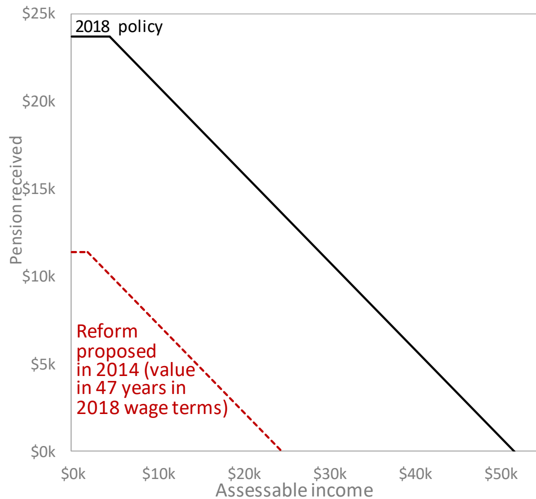
What should we discuss today? **Efficiency**

Inter-temporal distortions (work v retirement)

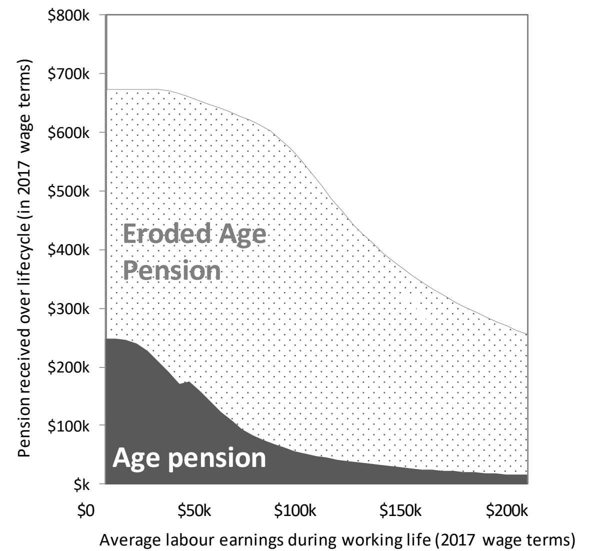
Inter-asset distortions (differential tax)

What should we discuss today? Risk

For example, political risk of changes to rules and regulations, like 2014 proposal to index pensions with CPI



Estimated lifecycle impact of 2014 reform for new entrants into labour market following reform, by earnings



What should we discuss today? Housing

% renters in poverty – incl. housing cost and imputed rent	Male 65+ who lives…			Female 65+ who lives…			Person 65+ who lives…			Cost of CRA change $2018
	with others	alone	all men	with others	alone	all women	with others	alone	all 65+	
CRA baseline	26%	61%	39%	26%	61%	44%	26%	61%	42%	-
CRA + 20%	22%	58%	36%	21%	56%	39%	22%	57%	38%	$190m
CRA + 40%	21%	42%	29%	19%	45%	33%	20%	44%	31%	$380m
CRA + 60%	20%	35%	26%	19%	42%	31%	20%	39%	29%	$570m
CRA + 80%	20%	34%	25%	19%	38%	29%	19%	37%	27%	$760m
CRA + 100%	19%	34%	25%	18%	38%	28%	19%	36%	27%	$950m

RIR says that CRA not enough and that "an alternative approach to assisting lower-income renters in retirement may be required". What?

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Questions?

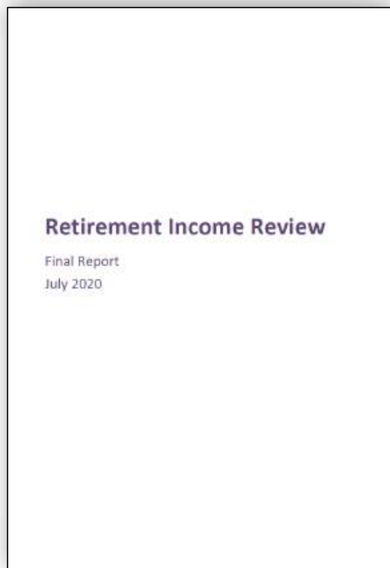
Attachment B

'Back to the Future' How the RIR Modelling Assumptions impact Future Outcomes

ISA Stakeholder Briefing 16 February 2021

Matthew Linden & Bruce Bastian

Retirement Income Review



- Recap of timeline:
  - Referred 27 Sep 2019
  - Consultation Paper 22 Nov 2019 (2 months)
  - Submissions closed 3 Feb 2020 (2 months)
  - Report to Government Jul 2020 (5 months)
  - Released 20 November 2020 (5 months)
- No interim report, no stakeholder lockup or briefing before release by Government
- There has been little or no critical assessment of analysis and modelling…

Retirement Projections - Assumptions

Overview (p25)

When it comes to assessing the outcome of changes to the retirement system, this inevitably involves long-term projections of 40 years or more. **There are no facts when making long-term projections.** The results depend on the calibration of the models used, the nature and comprehensiveness of the data and, most importantly, the assumptions regarding how the economy and retirement income system operate, along with the behaviour of people.

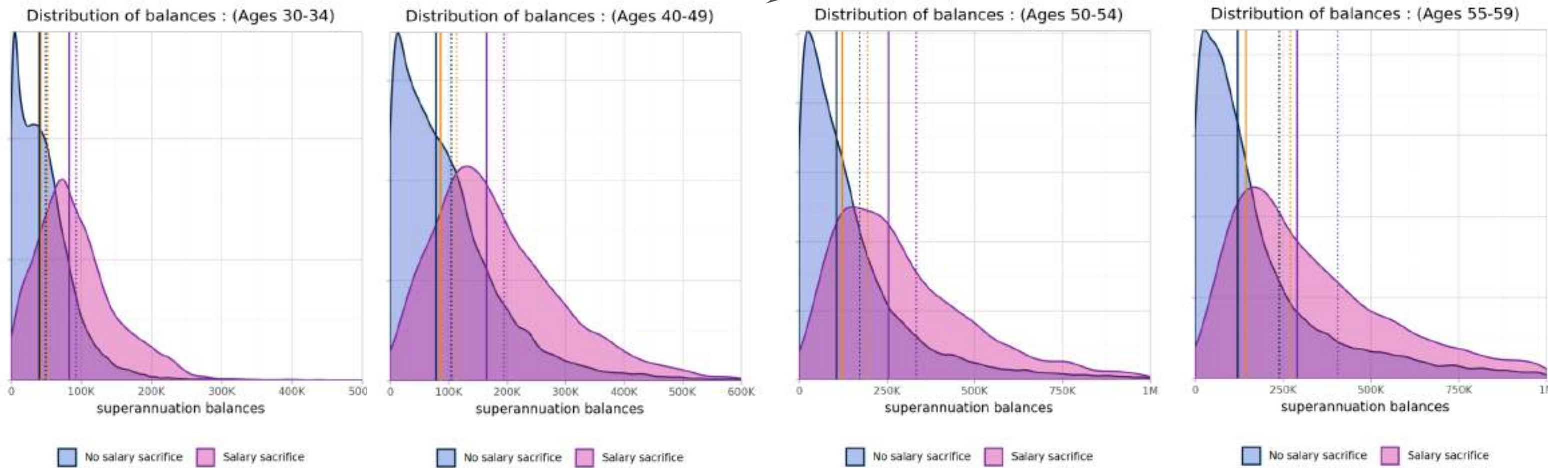
Small changes in underlying assumptions can have a significant impact on the results from modelling exercises. This is not normally highlighted when results are cited as support for a particular position being advanced.

How did the RIR model system adequacy?

- Baseline retirement projections utilised 9 illustrative single 'person' cameos
  - Further analysis of males, females, couples
  - Common assumptions generally used irrespective of gender and income percentiles
  - Selected sensitivity analysis which varied central assumptions
- No distributional analysis to examine differences within each of the 9 percentile cohorts modelled
- No substantive use of dynamic or microsimulation modelling which might capture such differences (MARIA)

Why does this matter?

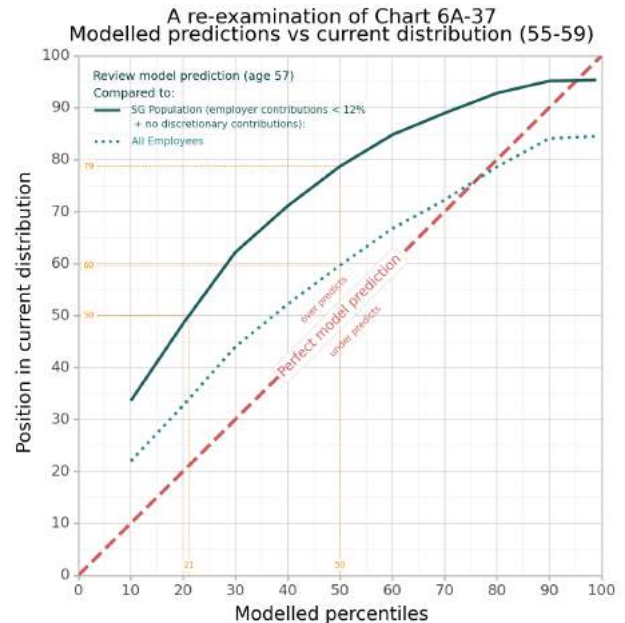
The SG plays a role similar to the minimum wage by providing safety net contributions for those who wouldn't otherwise save. This is a very different cohort to others that drive 'average balances'.



Source: ATO 2% tax file

Does the RIR modelling replicate history?

- The RIR produces some charts (p538) to suggest it does, except modelled outcomes are compared to the ATO 2% sample file *average* balance of age income percentiles:
  - Excluding balances without a contribution
  - Including those with voluntary and above SG contributions
- Direct comparison to balance percentiles shows significant overestimates <P90 57 y.o
  - 20 percentile has 50 percentile balance
  - 50 percentile has 78 percentile balance



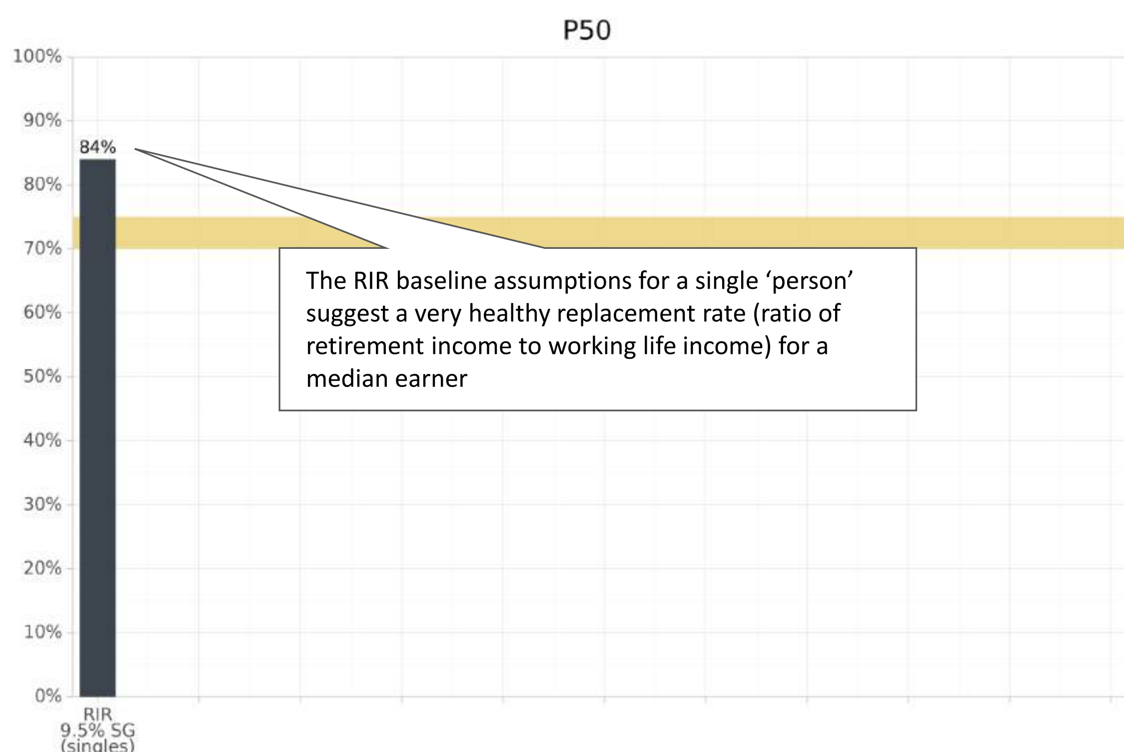
Source: ATO 2% tax file

Why does this matter, what explains it

- If the projections overstate accumulations then:
  - Replacement rates will be higher
  - Retirement benchmarks easily met
  - Case can be advanced that it's not necessary to increase SG

- Accumulation and retirement assumptions contribute (sensitivity analysis inadequate)

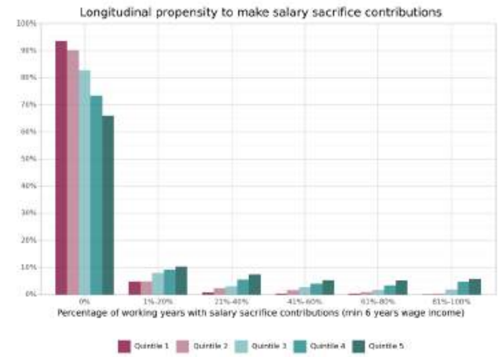
Accumulation Assumptions	Retirement Income Assumptions
– Everyone salary sacrifices – All benefits preserved (ignore COVID early release!) – Singles used for central case – 40 year uninterrupted working life (and every year SG eligible)	– No debt at retirement (irrespective of income) – Discount rates contrary to ASIC regulations – Savings fully drawn down (no precautionary savings)

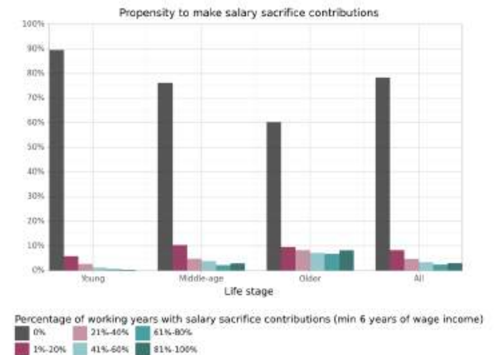


Source: ISA analysis

Salary sacrifice

- RIR assume all income cohorts of all ages salary sacrifice (using overall cohort av)
- The rate varies by cohort (income and age)
- Evidence shows this is not reasonable
- Perhaps only reasonable for P80/90 close to retirement
- So 9.5% SG is not 9.5%....

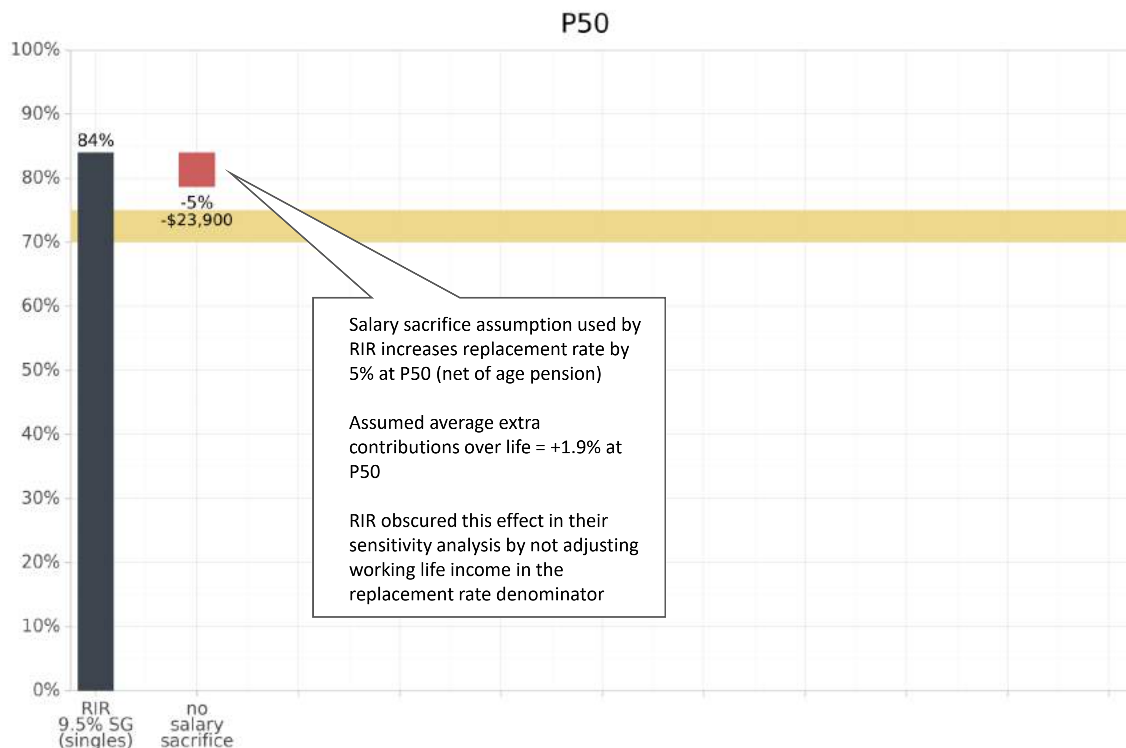




	P10	P20	P30	P40	P50	P60	P70	P80	P90
Average salary sacrifice	0.60%	0.90%	1.20%	1.70%	1.90%	2.10%	2.30%	2.30%	1.80%
Last 10 years	1.20%	2.00%	3.10%	4.60%	5.00%	5.60%	5.70%	5.80%	4.40%

Source: ATO 2% tax file

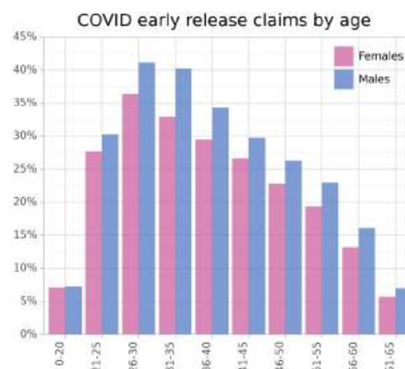
Source: HILDA, Wave 19 (years 2010-2019)

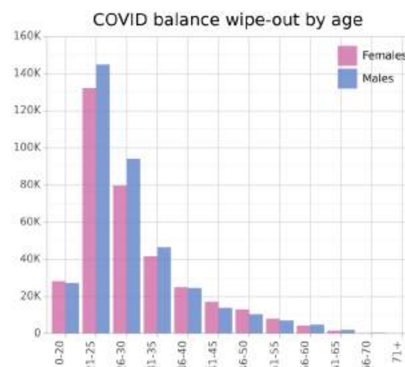


Source: ISA analysis

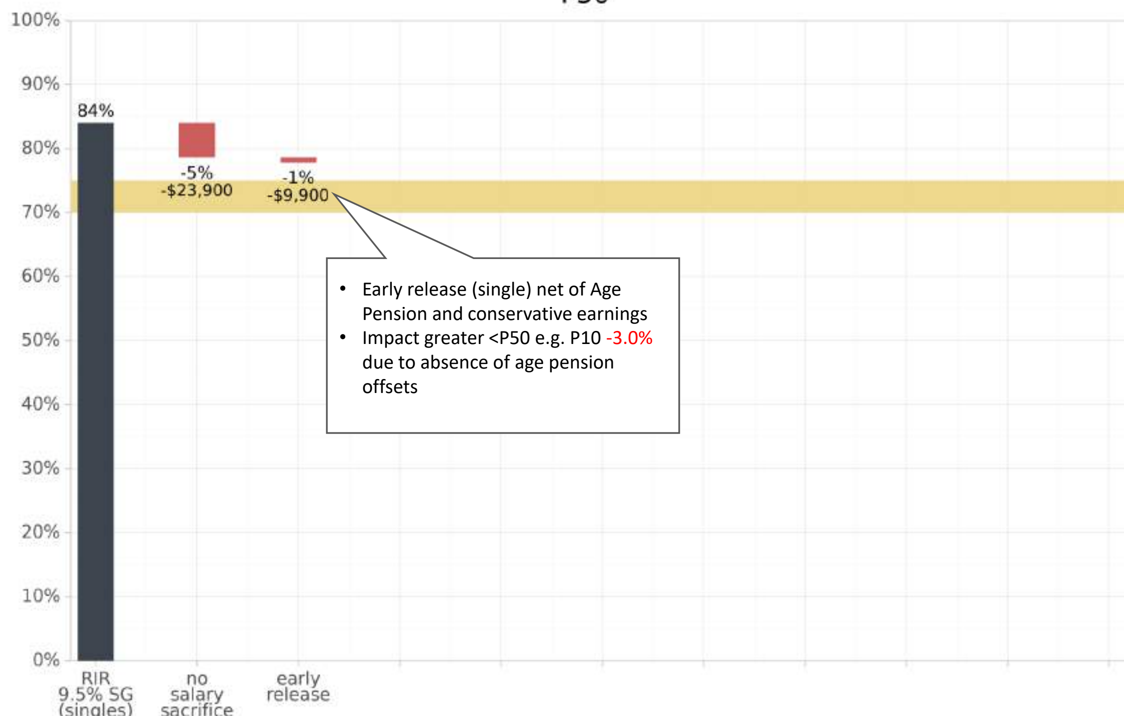
Preservation of benefits

- RIR assumes no capital withdrawal for any income cohort of any age;
- Not a reasonable assumption given COVID early release and existing early release provisions that <P50 likely to use
- Almost 40% of 26-35 yo used scheme and almost certainly more than half <P50
- Estimated 750,000 balances wiped out





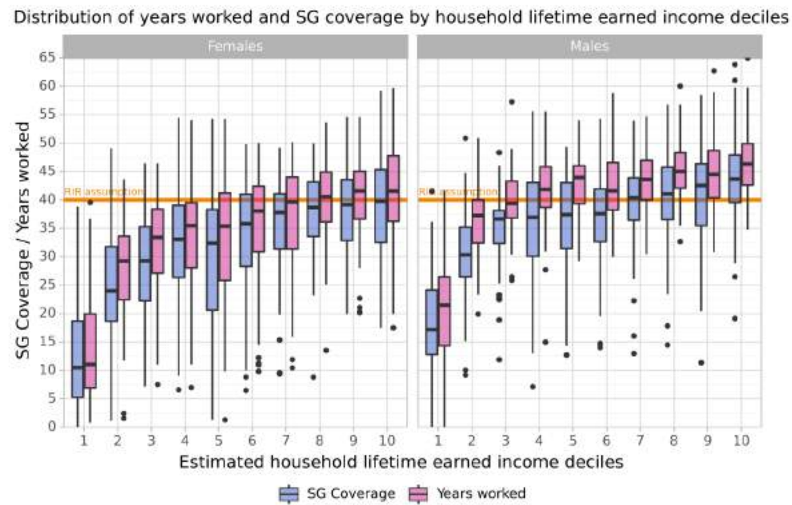
Source: ISA analysis of APRA, Treasury and ATO early release data, ATO 2% file and ABS payroll data.



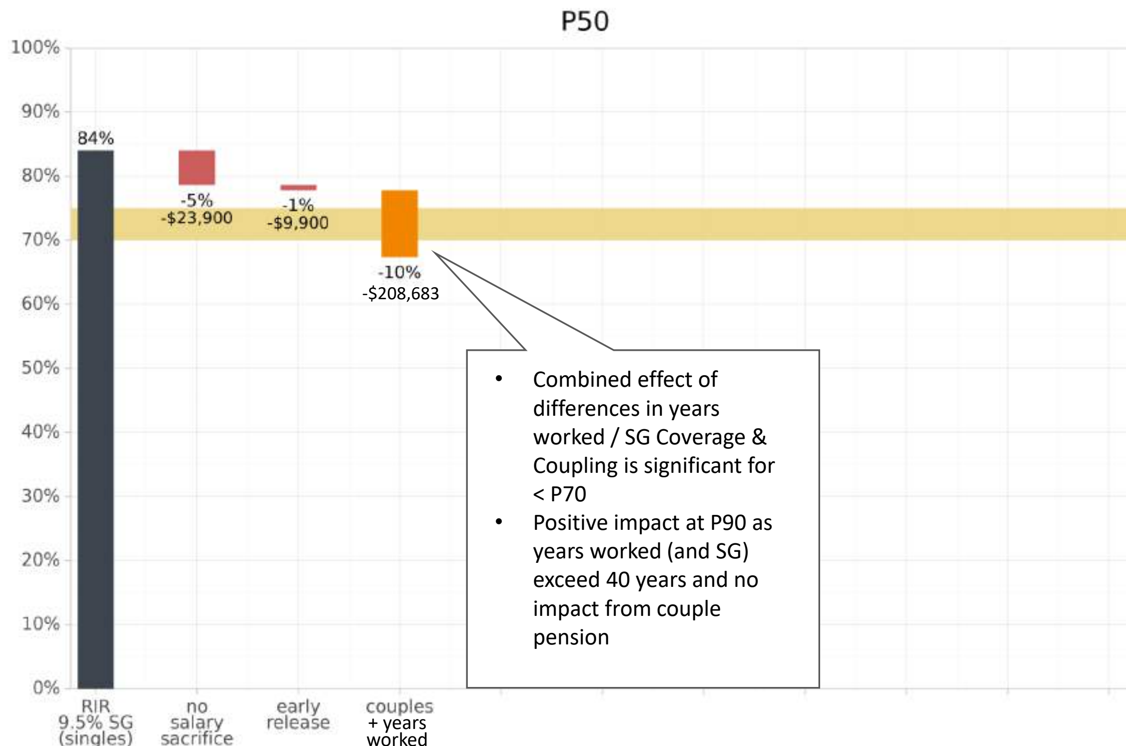
Source: ISA analysis

Working life and couples

- RIR assumes continuous 40 working life (and SG receipt) for all income cohorts and gender;
- Longitudinal analysis of HILDA shows two problems:
  - Working life varies by income cohort
  - Working life is not same as SG coverage
- Labour dynamics of couples important as is lower age pension rate for couples



Source: ISA analysis of HILDA Wave 19 (years 2001-2019)



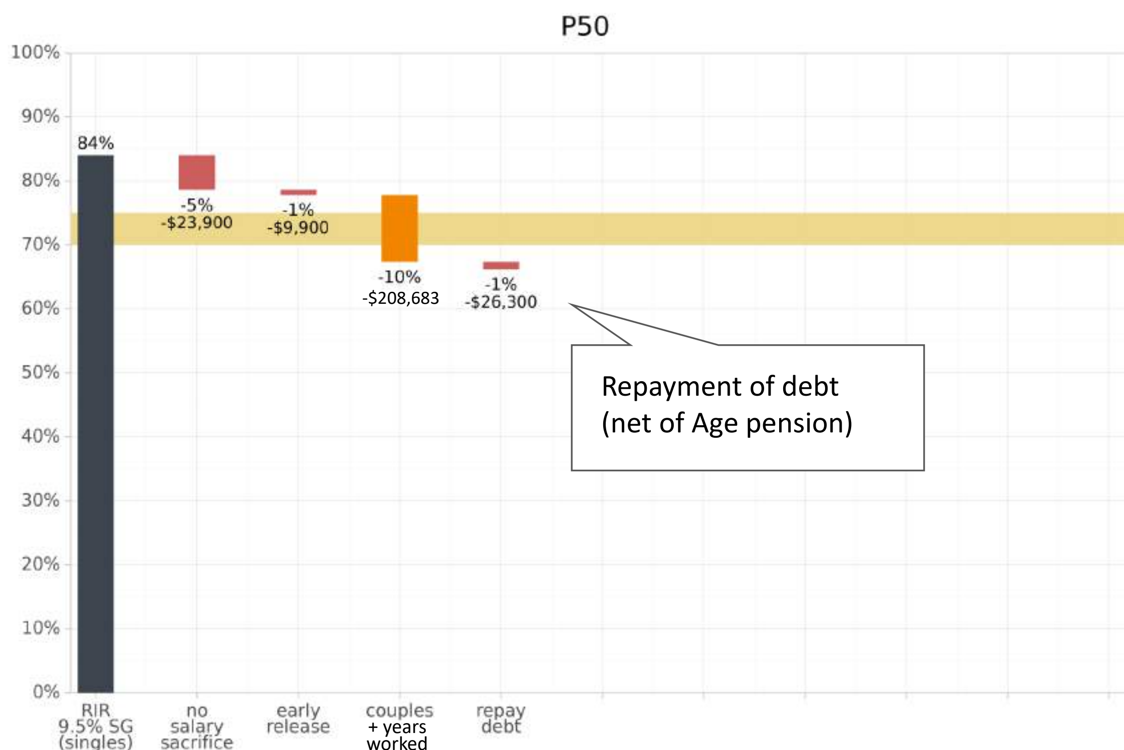
Source: ISA analysis

Debt at Retirement

- RIR assumes no debt is repaid at retirement for any income cohort
- It does so despite acknowledging the % pre-retiree's with debt has doubled since 2002
- Later homeownership + higher housing prices + lower interest rates point to debt repayment being usual in the future

	2002 Couples	2018 Couples
% with debt	19%	40%
Of those with Debt - Super left after repayment		
none	30%	40%
<20%	32%	45%
<40%	36%	54%
<60%	37%	62%
<80%	55%	72%

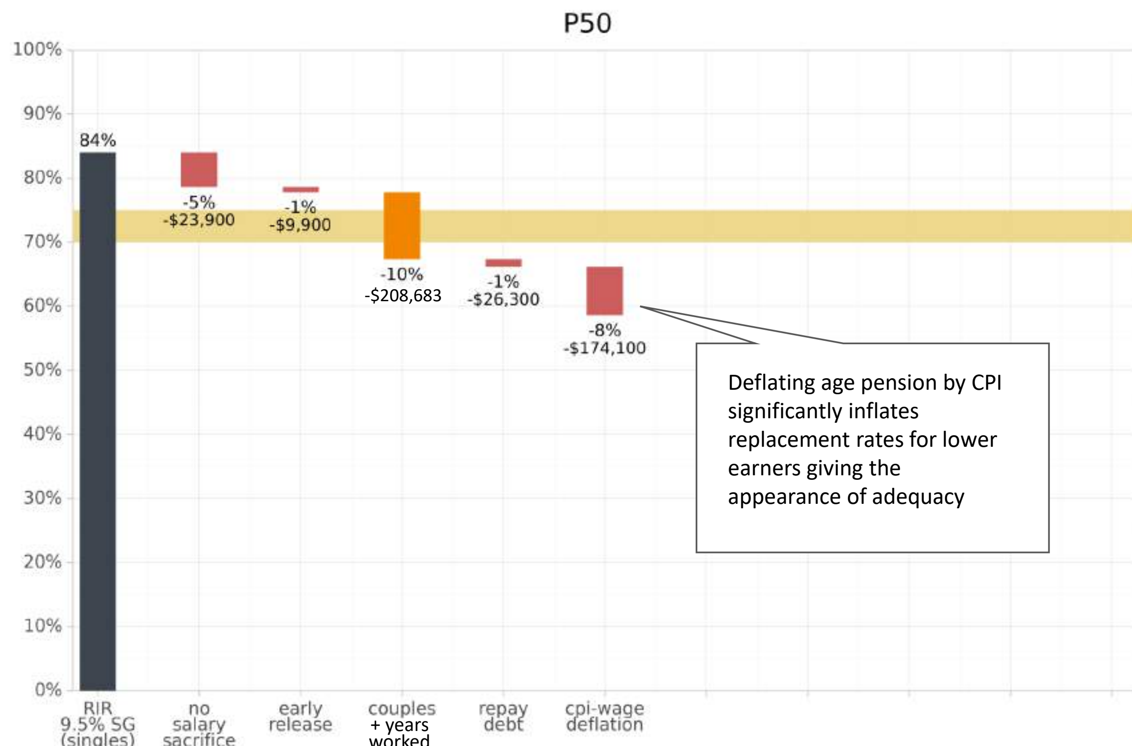
Source: HILDA Wave 19, years 2002 + 2018



Source: ISA analysis

How Future incomes are deflated

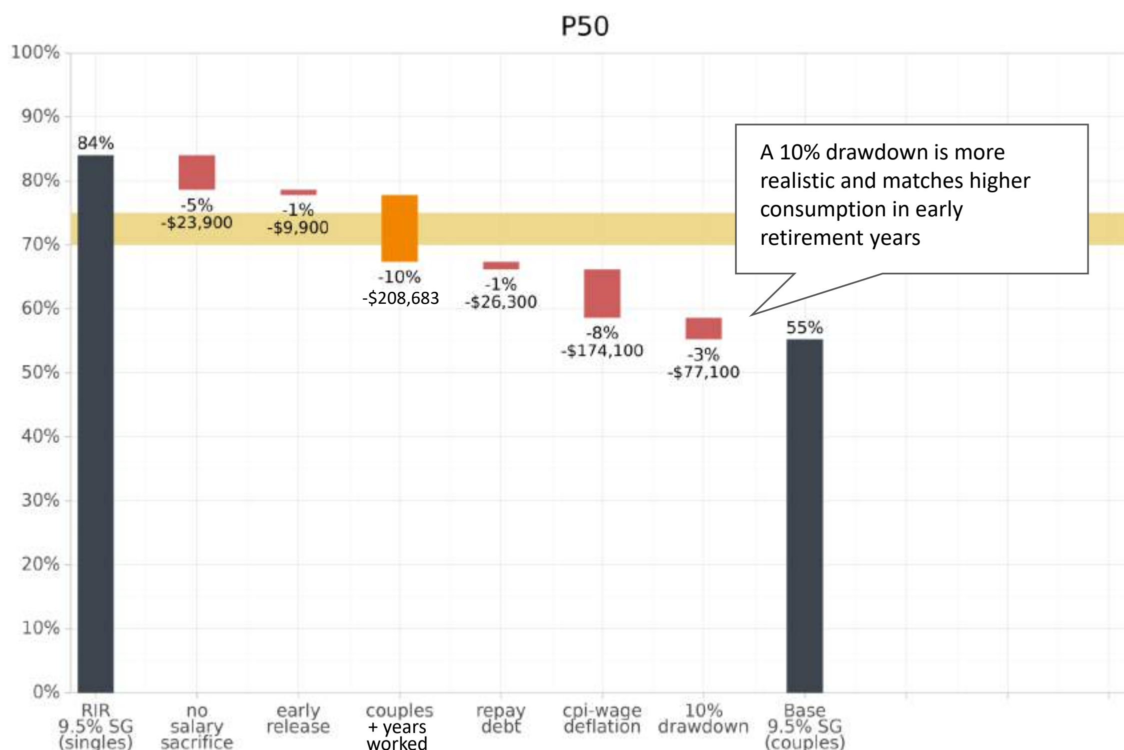
- RIR adopt a 'mixed deflator' for working life and retirement income;
  - Working life deflated by wages
  - Retirement income deflated by CPI
- This approach increases the numerator relative to the denominator resulting in higher calculated replacement rates
- RIR approach conflicts with ASIC regulations on retirement projections
- A reasonable approach would be to deflate wage indexed Age Pension by wages and Super by CPI
- RIR expenditure analysis excludes aged care costs which are linked to wages via pension quarantining



Source: ISA analysis

Drawdown of savings in retirement

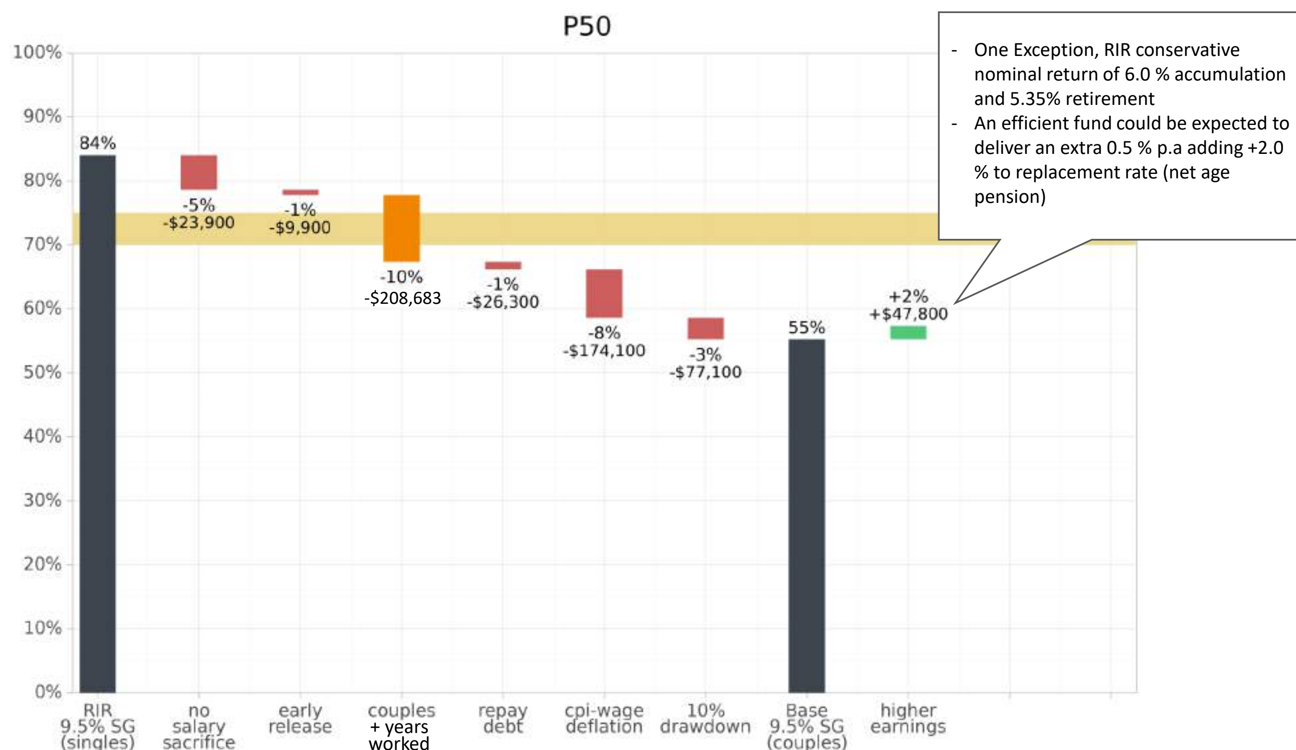
- RIR assume an optimised drawdown of assets to zero by life expectancy:
  - This increases retirement income and replacement rates
  - It ignores behaviour
  - It ignores reasonable precautionary saving (emergencies and funeral)
  - Higher drawdowns than minimum are reasonable (we use 10% p.a or minimum whichever is greater)



Source: ISA analysis

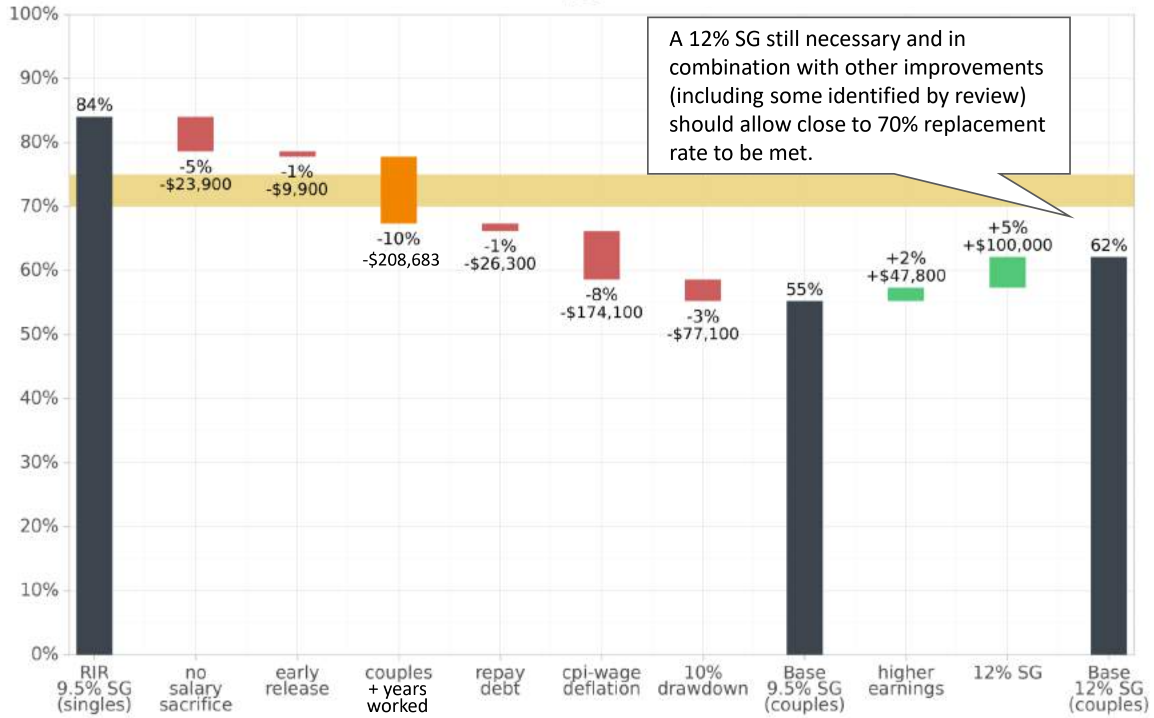
RIR Sensitivity Analysis

- RIR undertook extensive sensitivity analysis but only each assumption in isolation (not combination)
- Mostly presented for P50 where age pension interactions greatest (muting impact on replacement rates)
- The baseline assumptions all act to increase measured adequacy relative to more objective alternatives (and disproportionately overstate adequacy of lower earners)



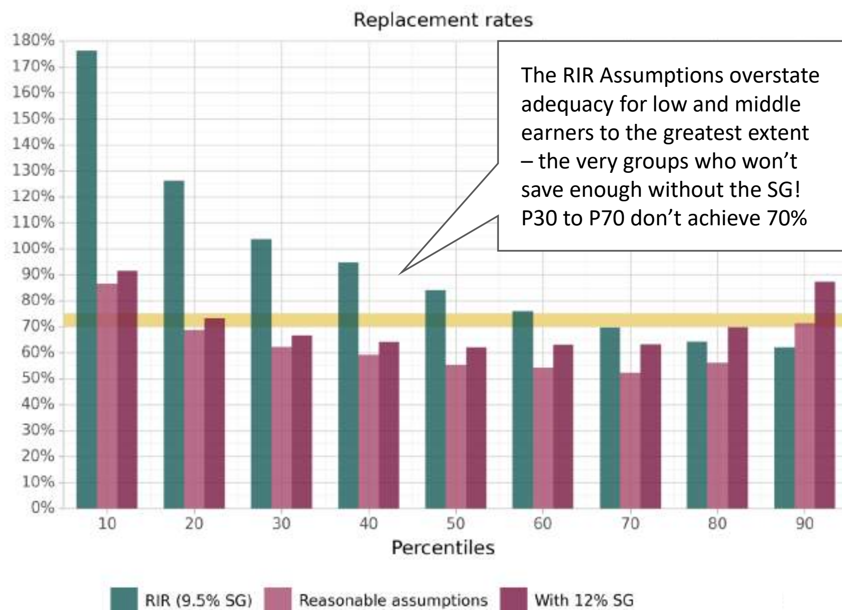
- One Exception, RIR conservative nominal return of 6.0 % accumulation and 5.35% retirement
- An efficient fund could be expected to deliver an extra 0.5 % p.a adding +2.0 % to replacement rate (net age pension)

Source: ISA analysis



Source: ISA analysis

Summary impacts by Percentile (couples)



Source: ISA analysis

Thank you

Full briefing paper
available shortly

What is the optimal use of superannuation savings consistent with the system's objectives?

Expert Roundtable, Canberra

4 March 2021

Dr David Knox

welcome to brighter

Some comments on the Retirement Income Review

- The objective: "to deliver adequate standards of living in an equitable, sustainable and cohesive way".
- Importantly, it also suggested that the system should facilitate people to reasonably maintain their standard of living in retirement.
- Net Replacement Rates of 65-75% are a good objective or guideline
- The system is complex but there was no significant exploration of solutions
- And … it was silent on the desirable features of products to achieve the objective

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Three objectives

- Three broad features should be available to retirees from the system
  – Regular income
  – Access to some capital
  – Longevity protection to provide confidence

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Desirable features of super's retirement products

- Different defaults for different cohorts of fund members
- Regular payments that last for life (i.e. some longevity protection for most)
- Allows for interaction with Government benefits
- Addresses the key risks faced by retirees (eg market, inflation, sequencing, longevity)
- Permits some access to capital
- Simple for members to understand and manage (if desired)
- Recognises it's not suitable in some circumstances (eg poor health, low balance)

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What do other countries do?
Has anyone got it right yet?

Country	Requirements
Canada	100% pension but LIF (DC) gives min & max; RPPP 0%
Denmark	100% annuity except for low-modest annual contributions
Finland	Fixed term (>10 years) or lifetime annuity
Israel	100% annuity; some have lump sums with severe tax penalty
Netherlands	100% annuity
Norway	Annuity till > age 77 and >10 years; if small benefit, shorter term
Singapore	Life annuity to provide a minimum pension; then choice
Sweden	100% lifetime or variable annuity
UK	No restrictions
USA	No requirement for account based plans

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Recommendations

- The super system must have a focus on providing income
- The Retirement Income Covenant is necessary
- Retirement income projections should be compulsory
- The current minimum drawdown rates need to be reviewed (they act as an anchor!)
- Super funds need to be able to offer suggested or default products
  - Guidance needs to be readily available
  - Financial literacy will not get us there

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An example of a default

- Single person
- Super balance at retirement is $500,000
- Account based pension (50%) – minimum and maximum drawdowns permitted
- Capital Access (25%) – total freedom
- Longevity protection (25%) – special means test rules apply
- Flexibility and options are permitted

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Unresolved issues … 1

- What indexation is desirable?
  - Wages – linked to community; Age Pension indexation
  - Prices – maintains living standards
  - Less than CPI – expenditure gradually reduces as we age

- Early retirement
  - Most people retire before pension eligibility age
  - Super is available for drawdown after preservation age
  - A seven year gap: does this lead to excessive saving?
  - Who is responsible? Implications for policy development

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Unresolved issues … 2

- The role of the Age Pension
  - Does the community trust it for the next 40 years?
  - Does it only target those in need?
  - The balance between public and private provision

- Is the Retirement Income Covenant enough?
  - Are CIPRs dead?
  - Should there be any requirements in addition to the RIC?

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To conclude

- Our system is not yet delivering the best possible outcomes
- We need the Government, the regulators and the industry to recognise this
- We need some agreed principles and some flexibility
- We are not there yet – there is work to be done!

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welcome to

brighter

Attachment D

What is the optimal use of superannuation savings consistent with the system's objective?

Professor Hazel Bateman

March 2021

Outline

- What does the RIR report say about the system's objective?
- What do people currently do with their superannuation at retirement?
- Optimal use of retirement savings
- Post Retirement Income Review – next steps

What is the system's objective?

- It is suggested that the objective for the system be developed around the goal:
  - – ***'to deliver adequate standards of living in retirement in an equitable, sustainable and cohesive way.'***
- What constitutes an 'adequate, equitable, sustainable and coherent' retirement income system needs to be clear and preferably legislated. Suggestions of the elements to be covered include:
  - **Adequacy**
    - : The system should ensure a minimum standard of living for retirees with limited financial means that is consistent with prevailing community standards.
    - : The system should facilitate people to reasonably maintain their standard of living in retirement.
  - **Equity**
    - : The system should target Government support to those in need.
    - : The system should provide similar outcomes for people in similar circumstances.
  - **Sustainability**
    - : The system should be cost-effective for taxpayers in achieving adequate retirement outcomes.
    - : The system should be sustainable and robust to demographic, economic and social change.
  - **Cohesion**
    - : The system should have effective incentives to smooth consumption and support people in taking personal responsibility for their retirement incomes.
    - : The system should interact effectively with other systems.
    - : The system should not be unnecessarily complex for consumers.

What is the system's objective?

Future retirement outcomes were modelled on the basis that retirees use their superannuation assets to fund their living standards in retirement. Importantly, and in line with the policy intent of the retirement income system, it was assumed that retirees will run down their superannuation assets by age 92. It is also assumed that they will not leave bequests and will purchase a longevity product at retirement that provides them with income from age 92.

Replacement rates are the most appropriate metric for assessing whether the retirement income system maintains living standards in retirement. They compare income in retirement with income while working and align with the objective of achieving a reasonable balance between living standards in working life and retirement.

The review has used a replacement rate benchmark of 65-75 per cent of disposable working-life income to assess the adequacy of retirement incomes. Evidence suggests this proportion of

Some concerns

- Emphasis on adequacy, but risks are important too:
  - Longevity risk
  - Market risk
  - Inflation risk
  - Contingency risk (need for liquidity)

- Product used in modelling not currently available:
  - drawdown to age 92 (account-based pension) + deferred annuity

What do we have to work with?

The RIR Report reminds us that resources to fund retirement include:

- (means-tested) **Age Pension**:

- **Mandatory superannuation (SG)**:

- **Voluntary saving**:
  - Voluntary superannuation
  - Housing assets
  - Financial assets

What do we have to work with?

The RIR Report reminds us that resources to achive the 'objective' include:

- (means-tested) **Age Pension**: safety net/minimum income + insurance (longevity, market risk, inflation)
- **Mandatory superannuation (SG)**: converted to account-based pension (income plus liquidity), immediate/deferred annuity (jncome plus insurance now/later)
- **Voluntary saving**: supplement standard of living (RR)
  - Voluntary superannuation
  - Housing assets: PLS, equity release, downsizing – income/liquidity
  - Financial assets: income/liquidity

What do Australian retirees currently do with their superannuation?

(Appear to be) reluctant to draw down capital and as a result leave large bequests

We should not be surprised:

- An account-based pension at the minimum drawdown rate is the **'effective default'**

Payment amount

☐ Minimum annual amount

☐ Specific amount of $ ☐☐,☐☐☐.☐☐ (gross amount per payment frequency)

- **Short menu (and poor knowledge)** of alternative products
- **Unaware of public support** (health,aged care) + **Age Pension skepticism**
- Precautionary saving to **self-insure** against (perception of) health costs, aged care expenses, other shocks (eg COVID-19)

Strong motivation to continue to save/draw down slowly in retirement

Saving/spending motive	
1. Self gratification	Enjoy life now as well as later
2. Future health, aged care expenses	Finance unforeseen health, aged care expenses
3. Autonomy	Remain financially independent
4. Security	Peace of mind
5. Surviving spouse/partner	Enable spouse/partner to maintain living standard
6. Other unforeseen expenses	Finance other unforeseen expenses
7. Liquidity	Enough cash on hand at any time
8. Life span risk	Not outlive wealth
9. Political risk	Protection against change in Age Pension/super rules
10. (Intended) bequest	Leave a bequest to a dependent or estate

Alonso Garcia et al. (2018), 'Saving Preferences after Retirement', CEPAR Working Paper 28/18

…….. and it's not all about bequests

Saving/spending motive	
1. Self gratification	Enjoy life now as well as later
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Alonso Garcia et al. (2018), 'Saving Preferences after Retirement', CEPAR Working Paper 28/18

Optimal use of superannuation savings

- Full annuitisation (Yaari, 1965) – limiting assumptions
- Later papers suggest mix of investment account (eg account-based pension) and life/deferred annuities, often with fixed public pension
- Iskhakov, Thorp and Bateman (2015) – investigated optimal mix of annuity and investment account in the Australian context (with a means-tested Age Pension)

ECONOMIC RECORD, VOL. 91, NO. 293, JUNE, 2015, 139–154

Optimal Annuity Purchases for Australian Retirees*

FEDOR ISKHAKOV
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SUSAN THORP
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We develop and simulate a stochastic lifecycle model to investigate optimal annuity purchases at retirement. Retirees can invest in risky assets, purchase fairly priced immediate or deferred lifetime annuities, and are eligible for a targeted safety net pension. We match baseline parameters to current Australian settings and conduct scenario analyses over a wide range of individual preferences and financial market outcomes. Except where individuals need to insure a consumption floor, both immediate and deferred annuity purchases are largely crowded out by the means-tested public pension. Welfare losses caused by zero annuitisation are small compared with the losses caused by completely annuitising all savings, particularly if wealth at retirement is low. Decumulation policy should ensure individuals are well informed of the insurance value of annuities and accommodate diverse choices.

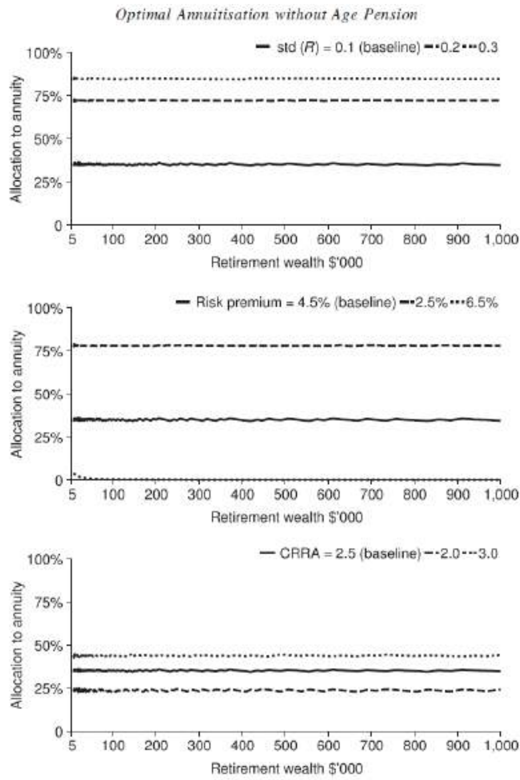
Setting:
- Single male homeowner
- Retires at age 67
- Super assets $0-$1m
- Housing assets as bequest

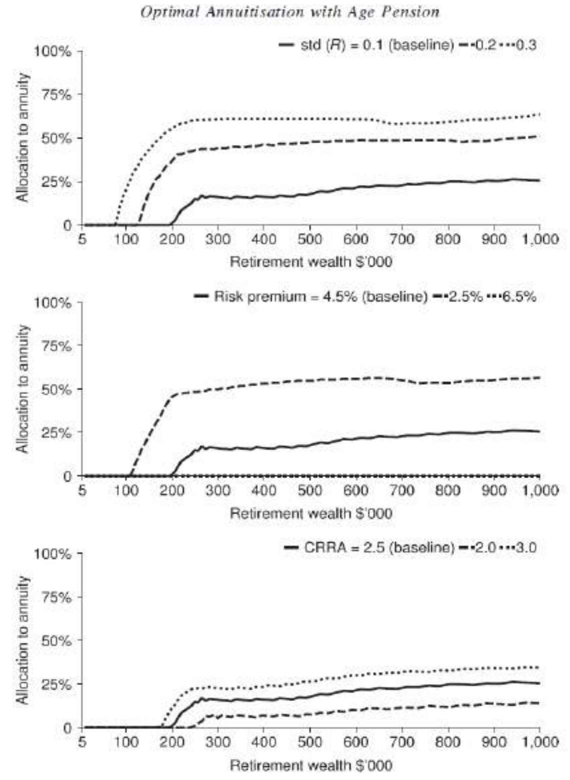
Consider:
- With/without age pension
- Immediate/deferred annuity
- Consumption floor

Vary:
- Volatility of returns
- Risk premium
- Attitudes to risk

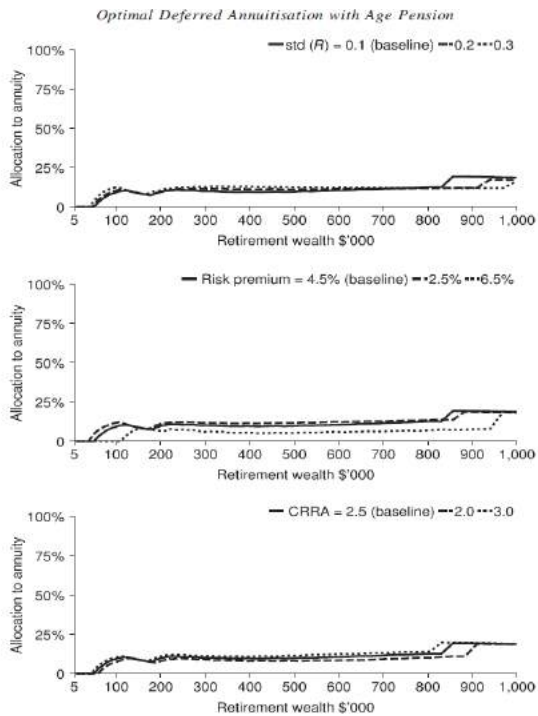
Find considerable variation in optimal mix of annuity/investment account

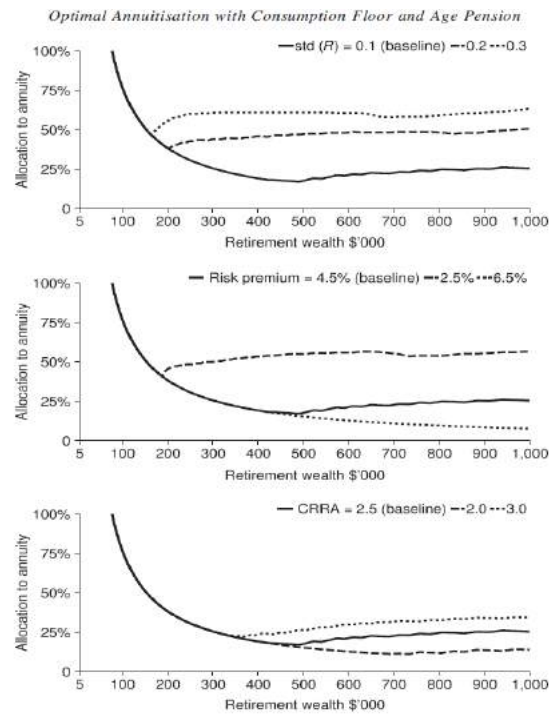
Optimal annuity purchases for Australian retirees





Optimal annuity purchase for Australian retirees





What does this suggest for ‘optimal use of superannuation’?

Iskhakov et al (2015) suggests mix of annuity (immediate/deferred) and account-based pension differs by:

- Age Pension eligibility
- Wealth
- Risk premium, volatility
- Attitudes to risk
- Consumption floor

Also important:

- Gender, spouse/partner, homeownership, financial assets, health status, (target replacement rate)

No ‘one size fits all’

Retirement Income Review - next steps

- **Government MUST facilitate confidence to drawdown**
  - Public information campaign
  - Provide retirement information from age 50+
  - Invest in MoneySmart, Financial information Service
- **Use an ‘income frame’**
  - Income projections with member statements in accumulation AND drawdown
- **Reconsider choice architecture**
  - Choice, incentives, recommendation, default, compulsion
- **Retirement Income Covenant should help**

Your Personal Retirement Income Estimate
Prepared 30 June 2013

Step 1. What will my Cbus account balance be at retirement?

Your account balance: $25,000 at age 39 in 2013

Your estimated account balance: $198,000 if you retire at age 67 in 2041

If you don't like the estimate call the Cbus Advice Team to work out a plan for you

What this estimate means

How this is worked out

Step 2. How much income will this pay me when I finish work?

Yearly income (when retired)

$11,200 pa Cbus account

$13,600 pa Your half of the Government age pension

Other potential sources

$24,800 pa Your yearly income in retirement

Adding up your income

About the Government age pension

Your other sources income

We can help you get a clearer picture

Step 3. What can I do to improve my estimate?

Contact the Cbus Advice Team

Call 1300 361 784 · Email · Visit

How much income will I need?

Get your own answers

Longevity · Average age of retirement · Pension · Pension rate

Four facts that will change the way you plan for retirement

Case study: What Justin thought about

Some of the strategies Justin discussed

- Combining his super into one account
- Choosing a different investment option
- Adjusting his super contribution levels

Your Personal Retirement Income Estimate
Prepared 30 June 2013

Step 1. What will my Cbus account balance be at retirement?

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$24,800 pa Your yearly income in retirement

Step 3. What can I do to improve my estimate?

Contact the Cbus Advice Team

Case study: What Justin thought about

Analysis of member behaviour (treatment vs.control)

- Increase in proportion of members making voluntary contributions and average amount
- 30% increase in proportion interacting with super fund and average number of interactions
- Small increase in active investment choice, average move towards riskier options

Smyrnis et al (2019a, b)

Income estimates in decumulation should assist drawdown

Revisiting choice architecture

- Free choice unlikely to change status quo
  - Lack of awareness and understanding of retirement income products (people and planners?)
- Chapter 2 FSI Final Report → Comprehensive income Product for Retirement as a 'recommendation' (*where did that policy go?)*
- Reconsider 'smart defaults': at retirement offer one of a fixed (short) menu of annuity/account-based pension combinations – determined by key characteristics (super balance, single/partnered, homeowner or not etc)

Concluding comments

- Optimal use of superannuation (ie combination of retirement income products to provide income, insurance and access to liquidity) – differs by household characteristics and preferences
- Post RIR ….. next steps …..
  - Facilitate the **confidence to spend** – remind people of public support - Age Pension, health, aged care etc….
  - **Communicate** super in **'income' frame**
  - Reconsider **'smart' default** for super drawdown

Some references

- Alonso Garcia J, H Bateman, J Bonekamp, R Stevens and A van Soerst (2018), 'Saving Preferences after Retirement', CEPAR Working Paper 28/18.
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- Yaari M E (1965), Uncertain lifetime, life insurance and the theory of the consumer, *Review of Economic Studies*, 32(2), 137-50.

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Achieving Cohesion: Reforming the Age Pension Means Test

Andrew Podger

ASSA/TTPI Roundtable

March 2021

Australian National University

Background

- Key assumption, implicitly endorsed by Callaghan Review:
  - Australia's retirement income system will continue to rely heavily on both means-tested age pensions and contributions-based superannuation
  - Most Australians can expect to draw on both
  - An increasing proportion, however, will not receive any age pension, possibly around 40% with around 30% on part pensions
- There is considerable merit in this approach
  - But also the challenge – highlighted by Callaghan - of achieving the coherence necessary for people to be able to plan with confidence a total retirement income that is adequate and secure

Comments on Callaghan Review analysis

- It understates the problems with the current means test
  - It does highlight the inequities from the different income and assets tests
    - People with different private resources currently get the same pension
    - Australia's unique use of two distinct tests inevitably adds to differences in treatment
  - But it understates its complexity and its failure to promote a focus on income
  - It claims the assets test taper does allow those with more assets to receive higher retirement incomes
    - This is only the case with very high rates of drawdown, in excess of lifetime annuity equivalents
    - Even then, at the margin, the trade off between reduced pre-retirement income and increased post-retirement income is extremely poor
  - It questions whether the test affects pre-retirement savings behaviour
    - But fails to consider how this might change if people are properly informed (as it advocates) about the incomes their savings will generate and their pension entitlement

- It also overstates the problems of options to address current weaknesses
  - It highlights the costs of relaxing the assets test taper without exploring whether the high thresholds might be reduced
  - It presents a particularly complex option for a merged means test
    - Ignoring simpler options identified in past reviews such as the Henry Review, or as actually applied in the past
    - Implying the need for the assumed income from assets to vary with age in the same way current drawdown rules operate, an approach it strongly criticises
  - Surprisingly, it does not explore options based on the actuarial value of assets in terms of lifetime annuities
- While very tight tapers, like the assets test taper, might be appropriate if a small minority faced them
  - They are inappropriate when very large numbers face them

Updating the old 1960s merged means test

- Under this test:
  - Assessable assets were converted into equivalent income streams over retirement years which were added to other income with the total subject to the tapered income test
  - The conversion factor (10%) was based on the CPI-indexed annuity a man aged 65 could in theory buy with the assets at that time
    - There was no variation by age or by gender or for prevailing interest rates
  - There was no threshold for the assessable assets
    - But the income test 'free areas' applied to the aggregated 'income'
  - The income test had a 50% taper above the free areas (as now)
  - Life annuities (typically, public sector defined benefits) were treated as income, including the return-of-capital component

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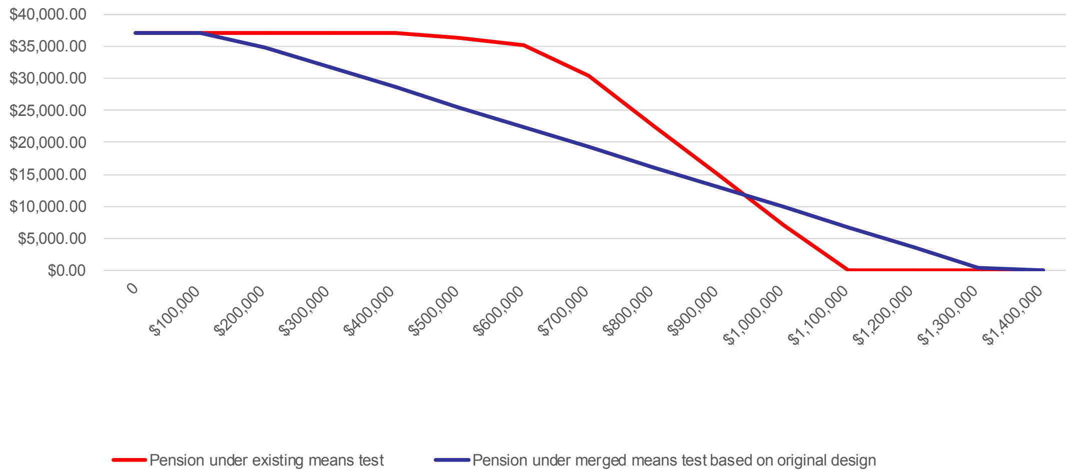
- Updated today, such a test might involve:
  - A conversion factor of around 6-6.5%
    - Currently the market for an annuity at age 67 is under 5% but if one assumed more standard real interest rates, no adjustment for selection bias, no residual benefit and no profit, then a factor of at least 6% would be appropriate
  - Annuities actually purchased to be treated as income
  - No separate assets test threshold, just the income test free areas
    - For those with no other income, the free areas would provide assets thresholds of around $130,000 for a couple and around $75,000 for a single person
    - There would be no difference for home ownership
  - The effective taper on assets above the thresholds would be 3-3.25%- say, 3.125% (50% of the conversion factor)
  - The following graphs use these parameters for those with no other income

publicpolicy.anu.edu.au

Australian National University

Impact of original merged means test model today Home-owning couple



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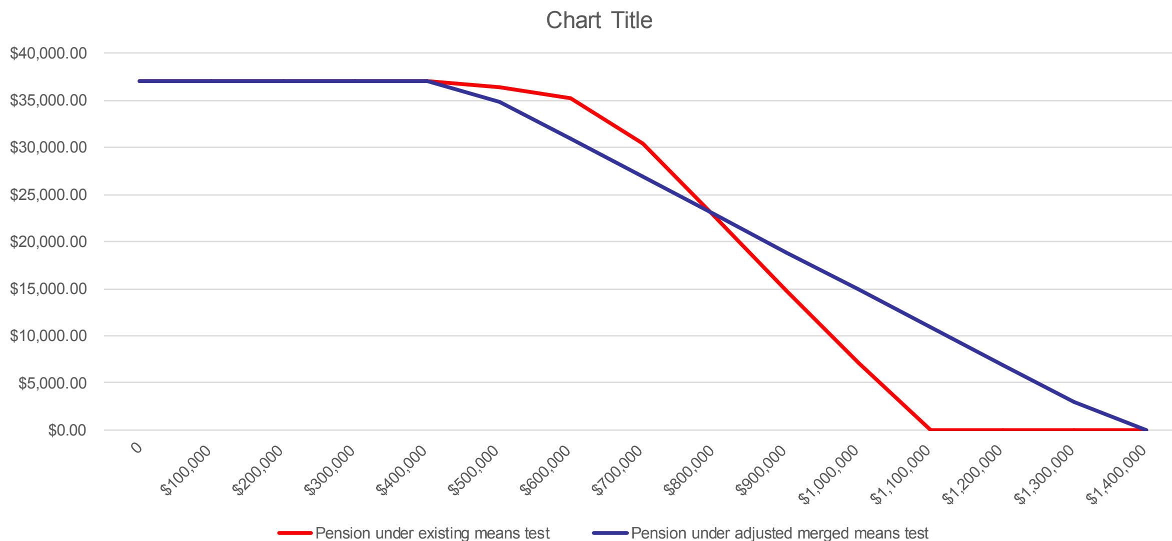
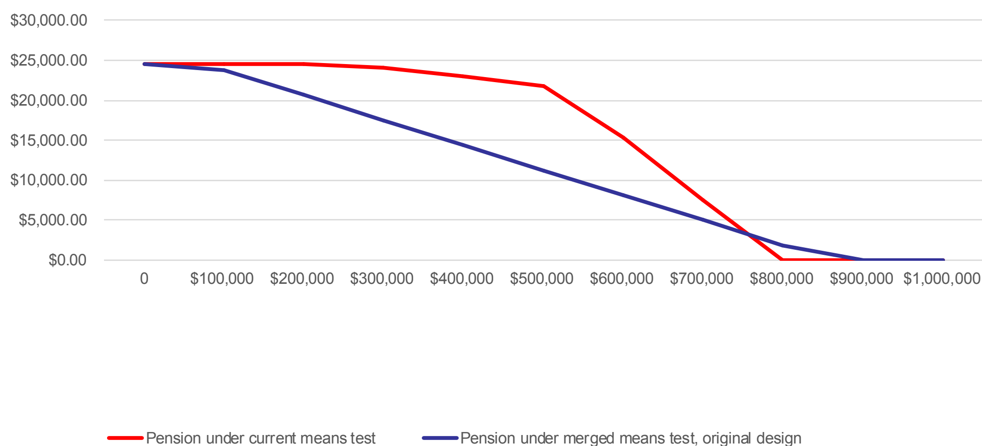
Impact of original merged means test model today Couple renting (excluding RA)



Impact of original merged means test model today Single home-owner

Australian National University

Impact of original merged means test model today Single renter (excluding RA)



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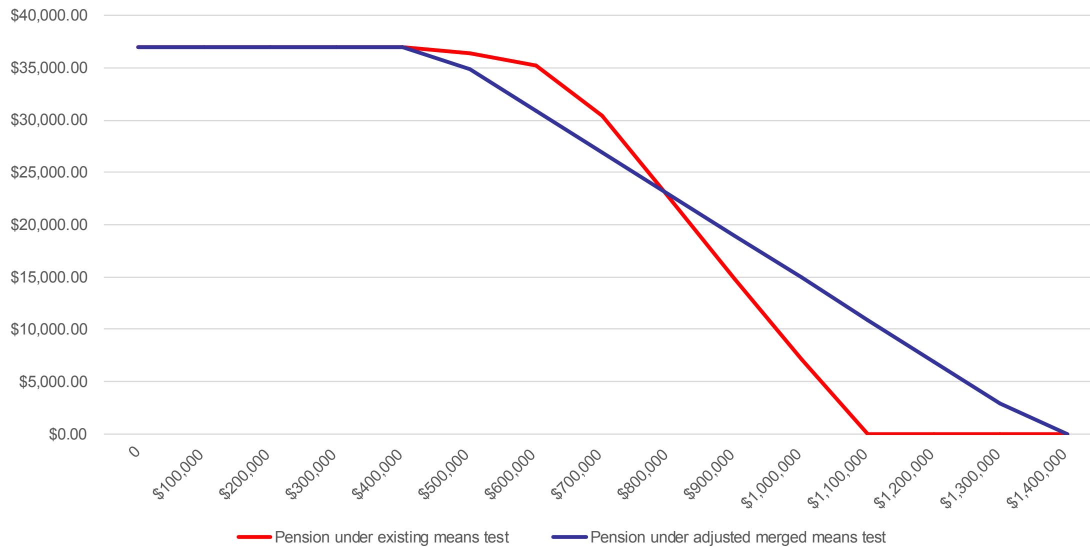
A modified, updated merged means test

- A number of modifications might be considered to moderate the impact of a shift from the current means test
  - A higher conversion factor could be justified, taking into account that higher annuities could be purchased at older ages.
    - For example, at age 75 the CPI indexed annuity for a man (including reversionary benefit for a surviving partner) would be around 8%
    - This would lead to an effective taper of 4%, similar to the taper applying before 2019
    - It would also ensure an incentive to purchase an annuity at a young age
  - Thresholds could be introduced for assessable assets, including variations according to home ownership
    - For example, $100,000 for a home owner and $350,000 for a renter (single or couple)
  - The following graphs use these modifications for people with no other income

Impact of modified version – 8% conversion and assets thresholds Home-owning couple

Impact of modified version Couple renting (excluding RA)



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Impact of modified version Single home-owner

publicpolicy.anu.edu.au

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Impact of modified version
Single renter (excluding RA)

Australian National University

Impact summary

- Winners and losers
  - Gains and losses moderated by adjustments
  - Non-home-owners mostly win (some couples lose up to $5,000 if have assets between $400k and $800k)
  - Home owners with assets between $200k and $600k ($400k for singles) would lose up to $7,000; those with more substantial assets win, but not as much as under the non-modified version
- Far less complex
  - Single test
  - Single, permanent conversion ('deeming') rate
- Focus on incomes
  - Enhances capacity to plan ahead and encourages life annuities

Other possible variations and options

- 'Grandfather' the change (no immediate losers)
- Set the income test free areas as % (eg 25, 30 or 40%) of pension and index
  - And/or adjust the income test taper
- Apply the test no more often than annually
- Include the value of the home
  - Even with a high threshold, this would probably more than offset gains amongst most high asset holders
  - Prerequisite is ready access to income streams from home assets
  - Politically heroic, particularly in the current context

Completing Australia's Retirement Income System
Simplifying the age pension means test

Expert roundtable
Crawford School of Public Policy, Canberra

Jeremy Cooper
4 March 2021

Intro
Key themes

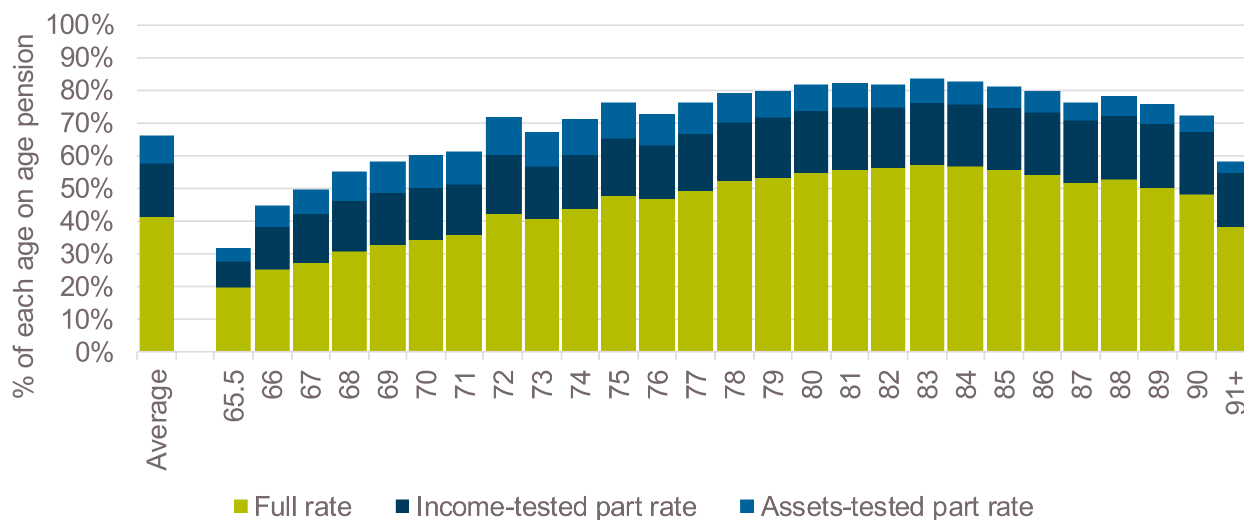
- Can't talk about the age pension without talking about super
- Total super assets at December 2020 exceeded $3 trillion – rapidly changing
- Consumption of retirement savings is the current 'battleground'
- Perfection can be the enemy of the good
- So long as we have means tests, they will be complex BUT can technology and a much better consumer interface help?
- Imagine Apple or Google designed a portal where Australians could find out how much age pension they were going to get?

Google

challenger

Younger retirees less likely to be on Age Pension

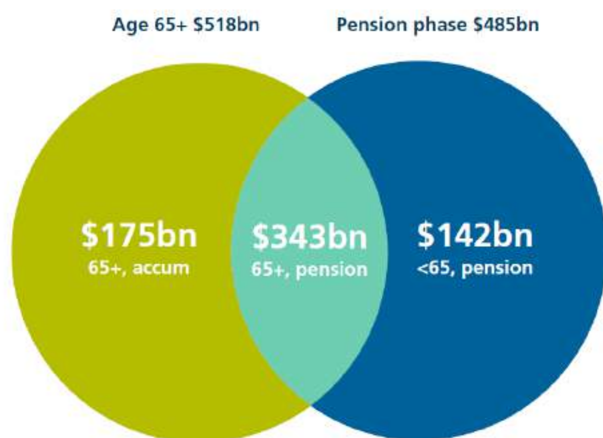
Age Pension recipients at Dec 2018 by age



Pension super balances

$1 trillion already in pension phase

Large APRA funds 2020



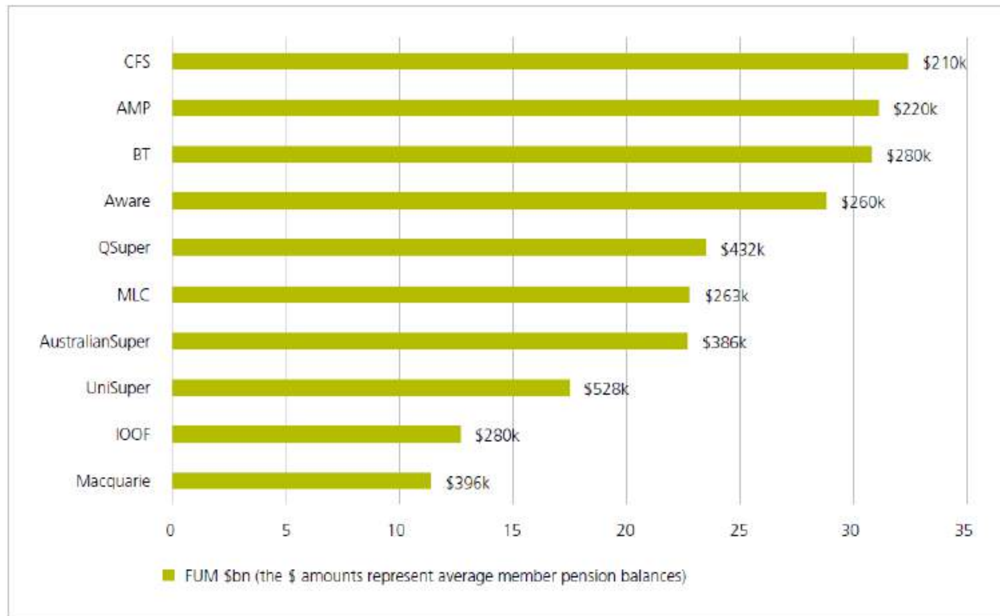
SMSF assets June 2018

$478bn in retirement phase in 2018

1. APRA Annual Superannuation Bulletin June 2020 edition, issued 29 January 2021 and ATO SMSF annual statistics overview 2017-18.

Large APRA funds pension balances – June 2020[1]

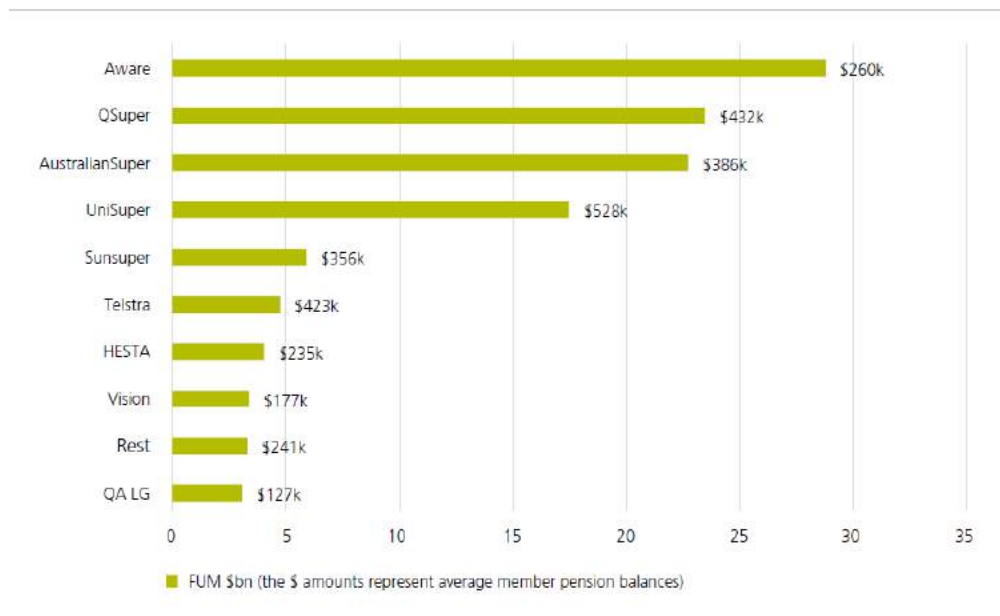
Top 10 funds ranked by pension FUM (totalling $233bn)



1. APRA Annual Fund-Level Superannuation Statistics report June 2020, issued 16 December 2020.

Industry funds pension balances

Top 10 industry funds ranked by pension FUM (totalling $117bn)



1. APRA Annual Fund-Level Superannuation Statistics report June 2020, issued 16 December 2020.

What are the problems?

What are we trying to fix with the age pension means tests?

The relevant problems seem to look like this:

1. Complexity of design
2. Disincentives to save
3. Differing treatment for retirees with the same overall wealth
4. Difficult transitional arrangements following any material changes
5. Unpredictability of future age pension payments
6. Lack of consumer awareness about the system and how it works

Better means tests

What could be done?

Merged means test	Deemed K consumption
Assets LE	Family home

What if not much changed?

What would be important in this environment?

- Assuming we more or less retain current settings:
  - when interest rates fall, deeming rates should go down, but the rules need to focus on the spending power inherent in the accumulated capital – otherwise, it just reinforces hoarding
  - don't relax the taper rates – they are working
  - don't reduce minimum drawdown rates every time the markets correct – this just reinforces hoarding and favours those in higher income deciles
  - lots of room for Services Australia to improve the consumer interface (more on that in a minute)

The 'retirement trap' – a behavioural barrier

Busting the myth

By-product of the 2017 taper rate increase to $3.00 per fortnight per $1,000 in assets.

Argument goes that part pensioners are better off on a full age pension and that there is no point contributing more to super because you can't earn 7.8% pa consistently.

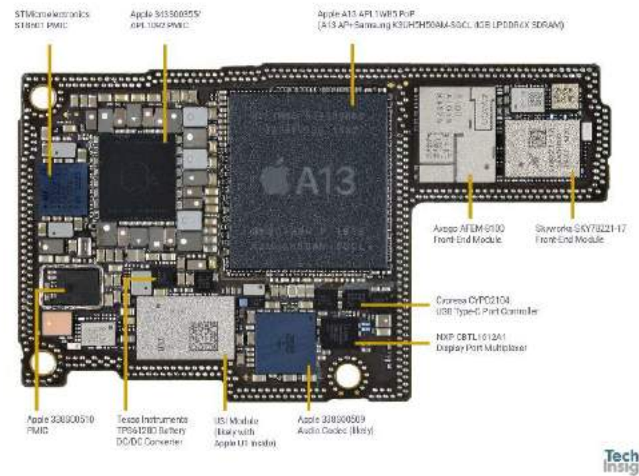
Gave rise to expressions like 'valley of death' and 'retirement trap'.

- Comes out in the RIR as well. 'Effective marginal tax' rate thinking
- It is just plain wrong - $1m in super is always worth more than $400,000
- 'Retirement trap' thinking ignores the consumption of capital as a means of support
- Consuming capital improves the standard of living for retirees
- As the RIR points out, the age pension buffers them as they consume savings
- Not all retirees can afford to live off their investment income alone – particularly with low rates!

Complexity of the means tests

Could this be solved at the consumer interface?

iPhone 11 Pro motherboard



Is there another way of looking at this?

- iPhones are complicated, yet simple to use
- Could we change the way we talk to consumers?
- Sophisticated digital tools could simplify
- Poor consumer interface is why age pension ‘concierge’ businesses like Retirement Essentials have arisen
- Could Services Australia provide a world class user experience (UX) like our tech giants?

Discussion

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Protecting the Vulnerable

Presentation at *Completing Australia's Retirement Income System, Implications of the Retirement Income Review Report*, Crawford School of Public Policy, Canberra, 4 March 2021

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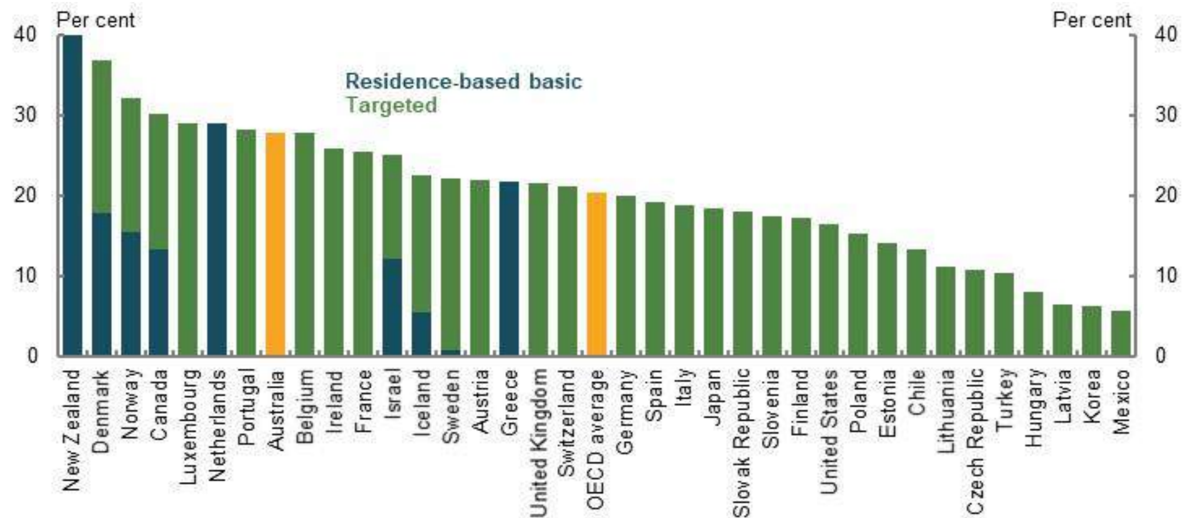
Introduction (and conclusions)

- Very long and somewhat diffuse report
- No specific policy recommendations – but arguably "implicit" directions.
- General impression that current support for the vulnerable adequate except for renters.
- Incomplete discussion of options e.g. public housing - "out of scope"?

Value of international safety net pensions as a proportion of average earnings

Source: p. 132



Who are most in need?

- "A significant number of older Australians who are renting in the private market need additional assistance.
  - In June 2019, around 133,800 single women, 86,800 single men and 79,500 couples received Commonwealth Rent Assistance on top of their Age Pension. P. 70
- Increasing the rate of Commonwealth Rent Assistance will only have a small impact. A new approach is required.
- For many who retire involuntarily due to job-related reasons, the adequacy of their living standards before Age Pension eligibility age depends on the level of the JobSeeker Payment. Renters and involuntary retirees experience higher levels of financial stress and poverty than the working-age population." (p. 18)
- Declining share of population 55-64 on payments (due to increase in female pension age and phasing-out of "dependency" payments – but increasing share of those remaining on lower payments.
- Increasing number of people over 65 on other payments – from 34,000 in 2009 to 189,000 in 2020.

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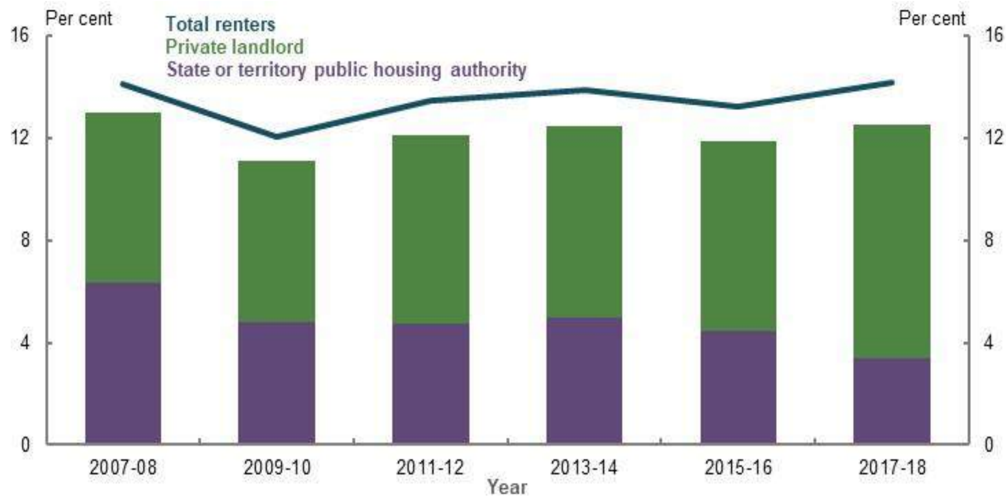
Proportion of households aged 65 and over that rent, by landlord type



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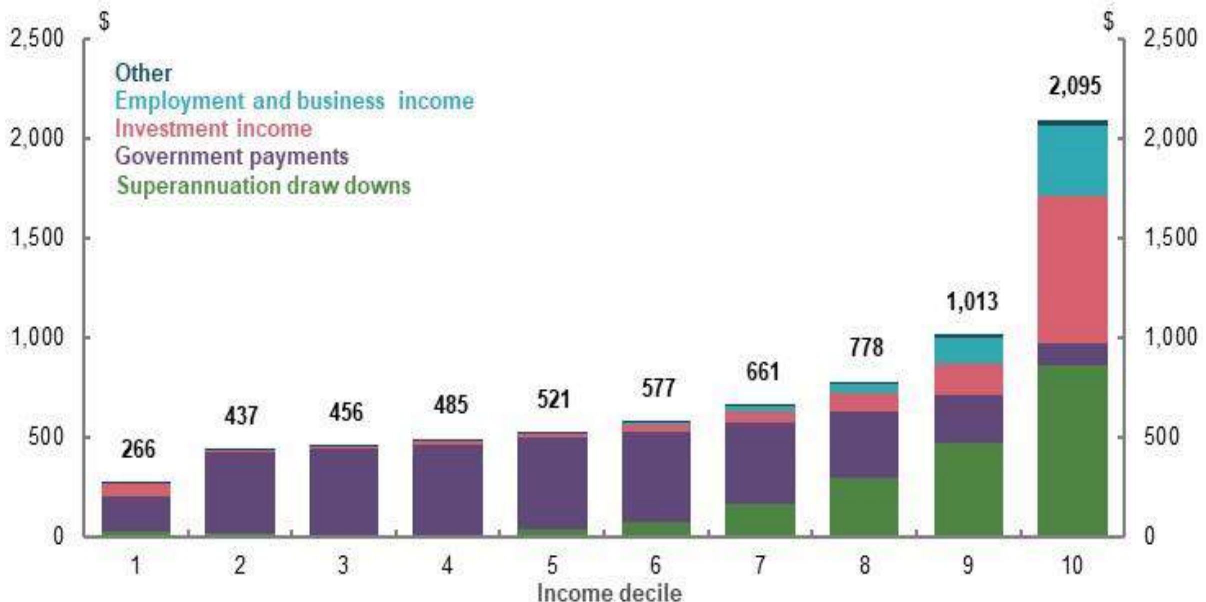
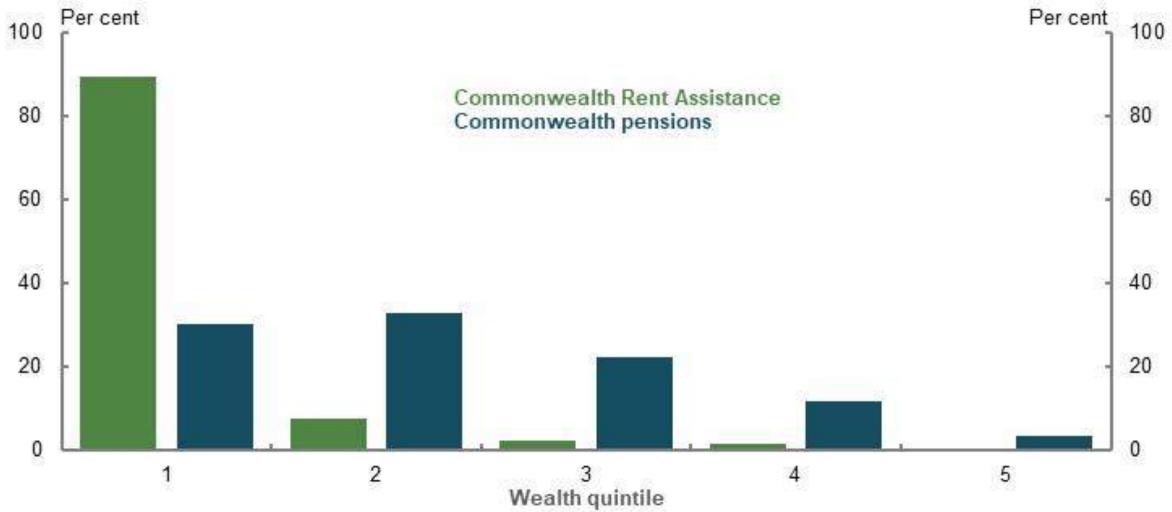
Equivalised retiree household weekly disposable income, by source and income decile

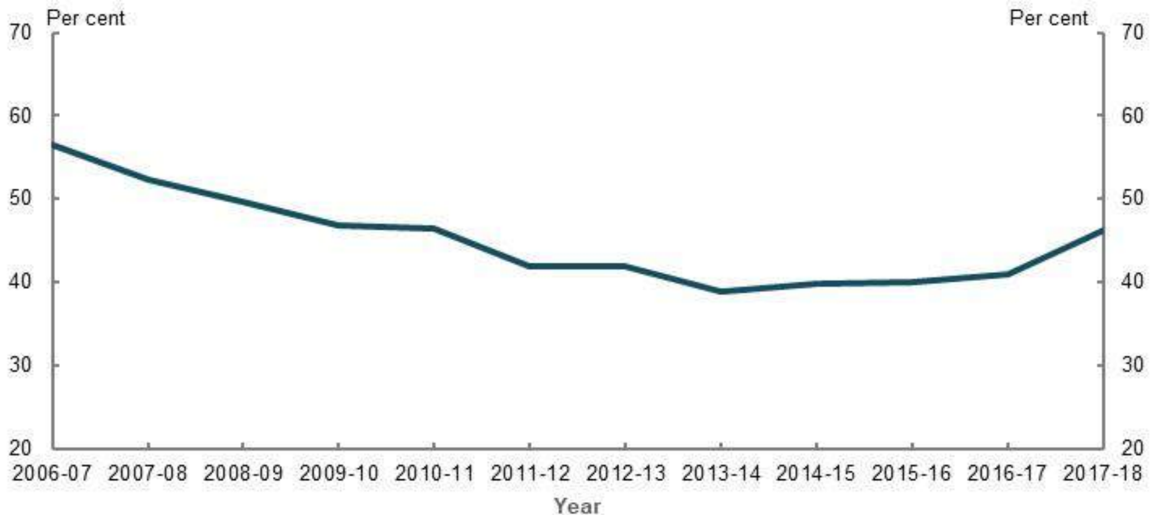
Note: Low government income at decile one is influenced by households with assets in excess of the Age Pension assets test minimum threshold who may be drawing on assets not well captured in ABS income survey methodology. Average equivalised net wealth for the first income decile is over $900,000. Values are in 2017-18 dollars. Source: Analysis of (ABS, 2019s)



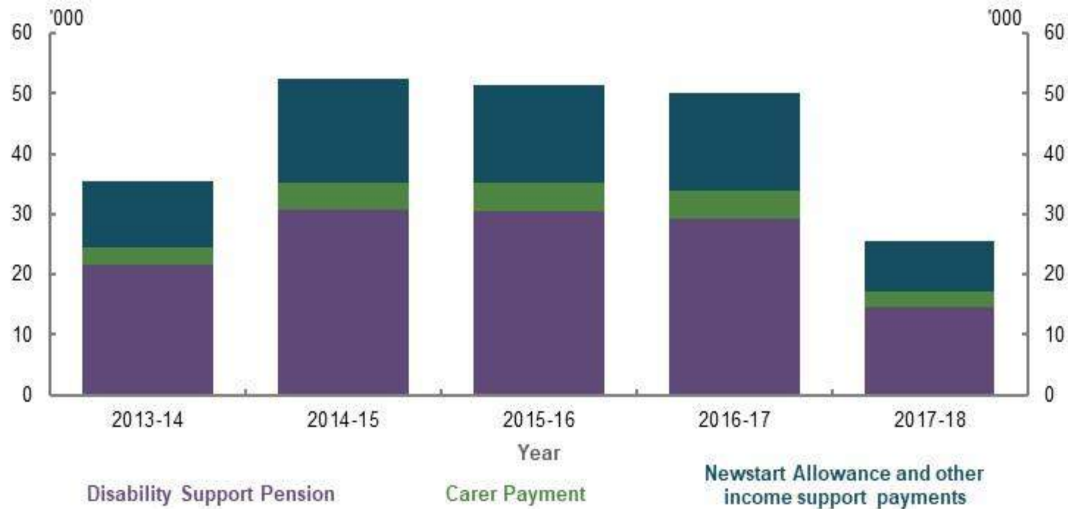
Government support for retired households, by wealth quintile



Proportion of people who were long-term income support recipients at Age Pension eligibility age



Number of people who were long-term income support recipients at Age Pension eligibility age, by type of payment



Concluding observations

- Why so little discussion of public housing if private renters are the most disadvantaged?
- How to help those on income support in years before pension age
- **“Encourage people to spend more of their savings in retirement.** This would likely reduce wealth inequality among future generations. Inheritances would be lower if retirees consumed a higher proportion of their savings during retirement, rather than dying with the majority of the wealth they had at retirement. Given inheritances are distributed unequally, this would assist in reducing intragenerational wealth inequality for future generations, but would mean some current younger people are less prepared for retirement. “ (p. 372) – Thinking through long-term implications

Attachment H

Using, and fixing, the housing pillar

Presentation at *Completing Australia's Retirement Income System, Implications of the Retirement Income Review Report*, Crawford School of Public Policy, Canberra, 4 March 2021

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Outline

- Housing issues in the review
- Housing costs and housing trends
  - Greater poverty among renters
  - More retired people renting and paying off mortgages, and this is likely to increase
- Policy options
  - Using housing wealth?
  - Rent assistance options

General points

- Home ownership an important ‘pillar’ of the Australian retirement income system
  - It reduces housing expenditure in retirement and hence increases non-housing consumption
  - It also is a store of wealth. But this is rarely drawn upon, except for aged care
- Age Pension
  - Income and asset tested, with own home not included in assets test
  - Renters have a (small) Rent Assistance supplement and (somewhat) higher assets test

Some housing-related points raised in the Review

- Home ownership rates have fallen for younger age groups, but been high and relatively stable for those 65+
- Unclear whether younger groups will catch up
- Private rental among those 65+ increasing
- The Review modelled a 40% increase in max rate of Rent Assistance
  - $0.4b cost for Age Pension recipients
  - Has only a small impact on poverty among renters
- The Review analysed the impact of the higher asset test for renters ($210k)
  - Less than typical house value, so renters disadvantaged
- The own-home exemption
  - Equity impact
  - Might lead to over-investment and non-downsizing (but impact unclear)

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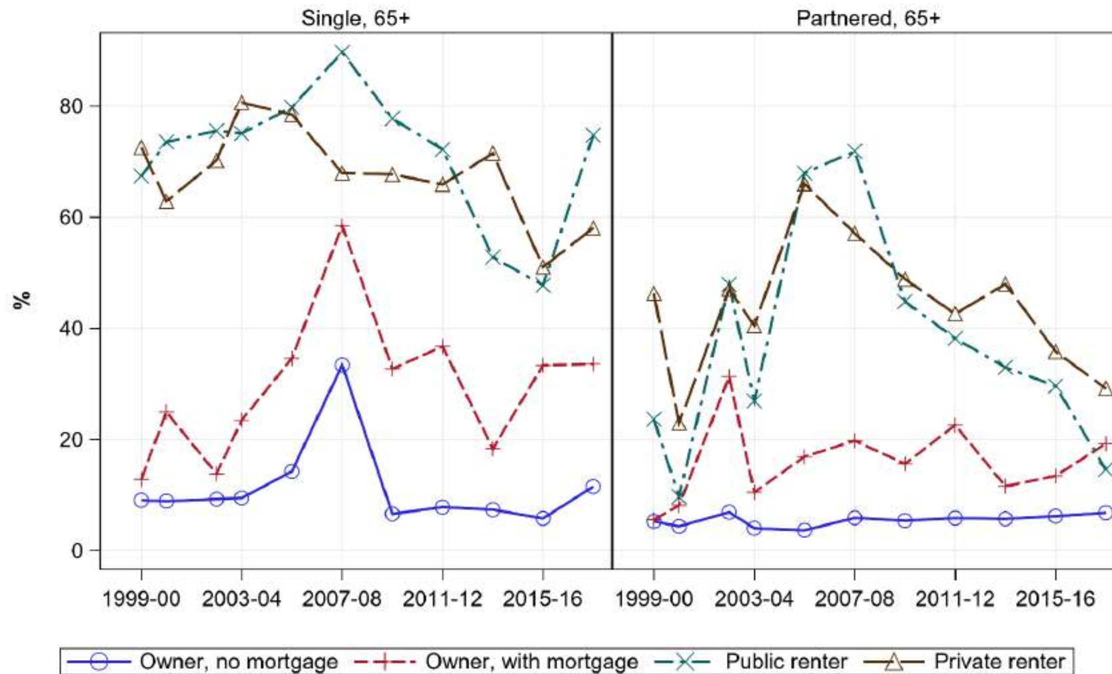
Trends in poverty after housing costs



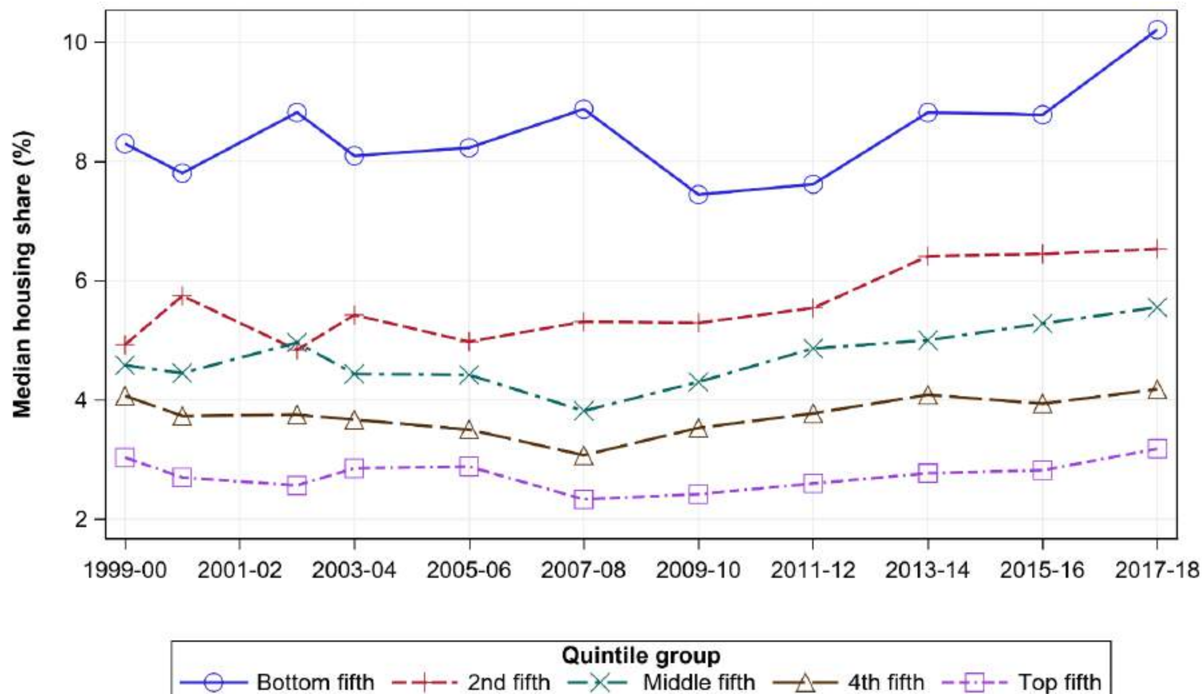
Poverty based on income minus housing costs.
Source: ABS Income and Housing surveys, unit record files.

Fewer outright owners and public tenants, more with mortgages and private tenants

		1999-00	2017-18	Increase
		%	%	Percentage points
Single 65+	Owner, no mortgage	72.3	68.8	-3.5
	Owner with mortgage	4.5	5.6	1.2
	Public renter	9.7	6.4	-3.3
	Private renter	6.0	10.8	4.8
	Other	7.6	8.3	0.8
	All	100.0	100.0	
Partnered 65+	Owner, no mortgage	87.1	81.6	-5.5
	Owner with mortgage	5.2	10.9	5.7
	Public renter	2.9	1.2	-1.7
	Private renter	2.4	3.1	0.8
	Other	2.4	3.1	0.7
	All	100.0	100.0	

Source: ABS Income and Housing Surveys, unit record files.
Population: Usual residents in private dwellings.

Housing costs increasing for low-income households



Quintiles are quintiles of household disposable income within each age group. Disposable income adjusted for household size. Households with self-employed and zero/negative income excluded.

Housing policy options

- For home-owners
  - Reverse-mortgage and similar products
  - Aged care financing
- For renters
  - Expanding Rent Assistance

Henry Review (2010) recommendations on Rent Assistance

- Current payment for single people in private rental market
  - For every dollar of rent above $62pw and up to $155pw (the 'cap'), 75c is paid.
  - Max payment is thus $70pw
- Henry: The Rent Assistance cap should be increased to around the 25th percentile of one and two bedroom dwellings in capital cities
  – My calculations for 2015-16: 25th percentile = $285pw
  – Would imply an **84%** increase in the RA cap
  – And a max payment of $167pw - a **140% increase** in the max payment
    - (vs a 40% increase modelled by the current Review)
- Henry: Should **not** vary with location
  – This higher cap would allow payments to vary with actual rents