Institute of Actuaries of Australia – Convention 2003

THE FUTURE FOR RETIREMENT INCOMES

by Geoff Dunsford and Vanessa Ho

SYNOPSIS

This paper discusses a number of the financial impacts of retirement.

These include adequacy of retirement incomes, and superannuation contributions required to meet them, the meaning and timing of retirement, work opportunities for older people, the need for a fixed Age Pension age, government budget impacts, funding of retirement incomes and the mismatching of investment returns with retirement needs, taxation, and financial planning.

The paper notes that the ageing of the population will contribute to increasing government budget deficits unless current welfare rules are changed. This includes Age Pensions where some 85% of new retirees each year claim a least a part Age Pension and the associated "fringe benefits".

A possible scenario is for the Age Pension to become a "Safety Net" for a minority, instead of the current means tested right for the majority. This could be achieved by requiring the benefits from accumulated compulsory super contributions to be used to purchase a pension up to the full Age Pension.

A suggested model is put forward which focuses on satisfying the likely expenditure needs of a range of retirees on the basis of maintaining their immediate pre retirement standard of living in retirement, while accommodating likely government constraints.

The model results suggest that the above standard could require, amongst other things, increasing compulsory contributions from 9% to 10% of earnings (exclusive of ancillary benefits), in conjunction with maintaining the current superannuation tax regime.

(This paper does not address current anomalies and complexities under the Social Security Age Pension and Means Test systems. These were intended to be covered in another paper. However this has not been completed in time for the Convention.)

The focus of the concurrent sessions for this paper will be the discussion of the issues and suggestions made therein. It is anticipated therefore that attendees will have read the paper in order to contribute to the discussion – which will be important input to a further IAAust submission to government.

The presentation will be no more than 10 minutes and will attempt to focus the sessions on the major issues.

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1. INTRODUCTION

Australia's basic financial structure to support retirees comprises 3 "pillars":

1. Government provided benefits
2. Compulsory Superannuation
3. Voluntary Superannuation

This basic structure is widely considered to be sufficiently flexible to be able to accommodate the needs and aspirations of the whole population. Certainly, the major political parties support it. Accordingly, for practical reasons, this paper accepts this structure as given.

At the same time, there are significant issues with the level of benefits, their form of delivery, anomalous outcomes and general complexity of the system.

In addition, changing work patterns and the concept of retirement, and the general ageing of the population raise issues which need to be addressed.

This is not a new problem. Because of the wide ranging impacts of Social Security and Aged Care expenditure, and Superannuation incentives on Taxation Revenue, governments have been required to maintain focus on the structure. This has inevitably meant piecemeal changes to meet short term political aims, thereby generating the enormous complexity and anomalous outcomes.

In May 2002, the government published its Intergenerational Report. This showed that, without changes to superannuation and welfare benefit rules and assuming no changes to the overall level of taxation, the ageing of the population would result in increasing budget deficits. This was despite the anticipated growth in self-funded retirement benefits driven by the Compulsory Superannuation Guarantee Scheme. (SG Scheme). A Treasury presentation made in conjunction with the launch of the report forecast that, in the year 2041, 55% of the incomes of those over Age Pension age would still arise from Social Security and Veteran Affairs pensions.

At the same time some surveys have suggested that the SG scheme, even when fully mature with members having contributed throughout their whole working lives, will not provide adequate retirement incomes for all.

Both major political parties have indicated their support for a full review. In December 2002, the Senate Select Committee on Superannuation published a report. This was compiled after receiving a large number of submissions from a range of people and organisations, including the Institute of Actuaries of Australia.

In its submission, the Institute suggested that the first action needed was to establish a set of principles for a long term retirement incomes system which meet bi-partisan support together with a retirement incomes target model.

Development of such a set of principles would need to take into account the wider social and economic impacts. Accordingly this development is outside the scope of this paper.

However, a possible target model is put forward, together with suggested transitional arrangements.

This model attempts to balance the needs of the lower to middle income people, the aspirations of those on middle to higher incomes, and the necessity for the current and future governments to address the ageing of the population budgetary issues.

It is believed that this model is likely to be consistent with the principles for a sound long term retirement incomes system.

2. CONCEPT OF RETIREMENT

2.1 Work Patterns

Retirement means different things to different people. It also comes at different ages for different people.

This has always been the case. 40 years ago when males were fully employed and most were expected to retire at 65, pilots retired at 55. Judges retired when they felt like it. And, of course most professional sports people "retired" from active sport by the time they were 40.

The Age Pension age, 65 for males, 60 for females, was a focus for most people for full retirement – i.e. when they ceased paid employment altogether. Accordingly, then, as now, those retiring earlier from a particular employment for whatever reason, tended to look for alternative paid employment until Age Pension age – except pilots who had good superannuation benefits at age 55 and didn't need to work again.

Today, work patterns are more uncertain, most females now expect to work full or part time for most of their working lives, and age discrimination laws in some states mean there is no fixed retirement age for the majority of the population.

Improving health and longevity has meant that many people aged in excess of 65 are able to work. In practice, redundancies and negative perceptions regarding older people's propensity to take up new employment, has led to many people effectively retiring from full time employment much earlier than Age Pension age.

Consequently, the range of personal situations is now so wide that the concept of retirement needs to be revisited.

In revisiting this concept, it will be important to keep in mind the wider needs of the community, as well as those of retirees themselves. In this regard, we note the likely strain on government budgets from the ageing of the population if no changes are made to current rules and practices. (Refer Appendix A – Intergenerational Report Forecasts)

2.2 Desire to Work

It is of clear advantage to the individual and the community if a person's desire for paid employment at an older age can be satisfied.

It will, of course, be necessary for such paid employment to benefit the employer. However, it will be equally important for the tax and social security systems to avoid discouragement.

2.3 Impact of Working on Age Pension

In the case of a person receiving a part Age Pension, the effective "tax" rate on the income from paid employment (i.e. tax plus reduction in Part Pension) can be up to 60%, plus the loss of fringe benefits. This severely limits the financial incentive to continue working. Certainly, those doing small amounts of part-time work may be disinclined to declare it.

A possible approach to dealing with this specific issue is to ignore say, the first $100 - $200 per fortnight of earnings from personal exertion, and then to apply a different (i.e. lower) Age Pension reduction in respect of the excess of such income, compared with that for investment/superannuation income, and not to withdraw fringe benefits.

The Pension Bonus Scheme, introduced last year provides a small incentive for those deferring claiming for the Age Pension and continuing to work. However the scheme is complex administratively and requires deferment for 5 years to achieve reasonable compensation for the deferment.

2.4 Encouragement to Work

A full study of ways to encourage older people to work is outside the scope of this paper.

However, it is worth noting that Federal and State Governments could seriously revisit their own public service employment practices with a view to (i) improving services; (ii) introducing more part-time work; and (iii) encouraging older applicants to apply for positions.

Larger service industry institutions could probably do the same while still maintaining their "bottom line" – on the basis that happier customers dealt with more efficiently are likely to do more business.

In this regard, many service industries focus on employment of younger people and offer the prospect of career advancement. Such younger people will therefore be keen to quickly move out of basic or routine roles. Even if they are quicker at such jobs than older people, the high turnover rate impairs overall efficiency. Older people in such jobs, particularly those with experience in the industry, could make for higher overall efficiency.

2.5 Age Pension Age

Currently this is age 65 for males and 62 for females, with the age increasing for females to 65 over the next 11 years.

The difference between the eligibility rules for Social Security benefits prior to, and after, Age Pension age is simply related to work. Prior to Age Pension age, the test is inability to obtain gainful employment. After Age Pension age, there is no requirement to attempt to obtain gainful employment, i.e. a person is allowed to consider himself or herself "retired".

Arguably, in a climate when the concept of retirement is vague and variable between individuals, there is no need for an Age Pension age. Benefits for inability to obtain gainful employment could simply continue, it being reasonably expected that the likelihood of such inability would increase with age.

However, there probably needs to be an age which the community recognises as the age where the *obligation* to seek work ceases.

At the same time, as the fitness and health of older people improves and their longevity increases, their numbers increase and their capacity to use goods and services increases. In short, if the Age Pension age remains unchanged, the cost of Age Pensions will suffer a “double barreled” increase.

Moreover, if older people are fitter and healthier, arguably they could continue working for a longer period.

There are arguments therefore for increasing the Age Pension age. Introducing a regular review to advise on reasonable change in the light of the change in longevity may eliminate the possibly emotive reaction to any change.

3. NEEDS AND EXPECTATIONS IN RETIREMENT

3.1 Needs, Wants, Expectations

Any reasonable analysis would demonstrate that needs, wants and expectations for most people in retirement are all quite different.

Yet, analyses based on surveys of individuals with regard to adequacy of retirement incomes frequently equate at least two out of the three concepts, and sometimes all three.

It is suggested that adequacy for retirement incomes means more than the absolute basics of living – sustenance and accommodation. Adequacy should recognise the human need to participate in the wider world, to socialise. Consequently, adequacy should accommodate the need to live in accordance with contemporary living standards.

Two further factors must also be taken in to consideration: changes in expenditure requirements for those moving from working to retired, and taxation.

3.2 Changes in Expenditure Requirements

Expenditure Requirements for each individual change continuously over the life cycle. A generalised summary for a significant proportion of the population might be:

Life Stage	Expenditure Needs
Student	Social only
Worker without children	Rent/Mortgage, Work related, Sustenance, Social
Worker with children to support	Larger Mortgage, Work Related, Sustenance and Social for whole family
Worker as "empty nester"	Smaller Mortgage, Work Related, Sustenance and Social
Retired, Active	Sustenance and Social
Retired, Inactive	Sustenance and Support

The timing of the changes in terms of age will vary between individuals. However, for the majority of people, the average annual expenditure needs over the lifetime period after age 65 are significantly lower than those averaged over their lives from starting work up to age 65.

In addition it is worth noting that most people would expect to earn sufficient income during their working lives to save a part of it, to add to superannuation benefits for retirement.

3.3 Taxation

Currently, retired people receive significant tax concessions. Those receiving pensions obtain rebates – broadly either 15% of pensions arising from taxed superannuation proceeds or a "capital content" factor in the case of pensions arising from "Undeducted Contributions".

In addition, those over Age Pension age whose total earnings are below specified limits receive "tax offsets" and other rebates not available to those below Age Pension age.

It should also be noted that workers incur work-related expenses. These can vary in the level of significance between those in different occupations.

Comparison of "adequate incomes" before and after retirement should take these differences into account.

3.4 NATSEM Study

3.4.1 Budget Standards

NATSEM (National Centre for economic Modelling at Canberra University) carried out a study for CPA Australia and Tower Financial Services in 2001.

The NATSEM study used a set of *Budget Standards* developed by the Social Policy Research Centre to compare the basic expenditure needs of different types of households. These *Budget Standards* are based on expert assessments of the expenditure required to achieve a "Modest but Adequate" standard of living: that is, to live in modest comfort with few luxuries, according to contemporary Australian standards. They take account of a wide range of expenses including the costs of children, housing costs, food, leisure, and so on. The budgets vary in accordance with household size and other needs.

3.4.2 Budget Standard Items

Examples of "Budget Standard" items are:

	Annual Cost ($)
Home owners with no dependents	
- couples	$19,500 ($21,247)
- Singles	$13,260 ($14,448)
Cost of children	
- aged 5-12	$6,760 ($7,366)
- aged 13-16	$7,540 ($8,215)
Costs of Working	$1,040 ($1,133)

The numbers in brackets represent those applicable at the end of 2002 consistent with changes in MTAWE over the period 5/00 to 5/02, which were the bases for the Age Pension at the end of 2000 and 2002 respectively.

The use of these *Budget Standards* enabled NATSEM to compare (amongst other things):

— retirement living standards with the "Modest but Adequate" benchmarks;

— retirement living standards with living standards prior to retirement.

3.4.3 Living Standards Index

Each individual or family's cashflow position at a stage in their lives is presented as a "living standards" index.

Consider a middle income couple with two children, at 3 stages in their lives. One partner is assumed to earn 100% MTAWE and the other partner 75% MTAWE. Income, outgo and relative living standards may be presented as follows:

	Couple with dependent children ($'000s)	Couple as "empty nesters" ($'000s)	Couple retired ($'000s)
Gross Income			
Earnings	75.2	75.2	0.0
Pensions	0.0	0.0	37.6
Income Support	2.1	0.0	0.0
Total Gross Income	**77.3**	**75.2**	**37.6**
Less			
Income Tax	16.3	16.3	0.0
Voluntary Super Contributions	0.0	7.5	0.0
Housing Costs	15.7	15.7	2.7
"Discretionary" Income	**45.3**	**35.7**	**34.9**
"Modest but Adequate" living standards benchmark			
Cost of 2 adults	21.2	21.2	21.2
Cost of working	2.3	2.3	0.0
Cost of children	15.6	0.0	0.0
Benchmark	**39.1**	**23.5**	**21.2**
Living Standards Index			
Living Standards Index Discretionary Income Benchmark	**1.16**	**1.52**	**1.65**

3.4.4 Couple with Dependent Children

To develop the index, we start with gross Income and deduct basic expenditure and savings, i.e. income tax, employee super contributions, housing costs. This result is defined by the paper as "Discretionary Income".

Gross income includes Social Security Family Benefits.

Voluntary super contributions are assumed to be zero during the heavy expenditure, dependent children period of the couple's lives.

Housing costs assume repayment of a mortgage over the working lifetime.

The "Living Standards" index of 1.16 then represents the ratio of "Discretionary Income" to the "modest but adequate" living standards expenditure benchmark.

3.4.5 Couples as "Empty Nesters"

The second column of figures assumes that the children are no longer dependent, and that 10% of earnings voluntary super contributions can be afforded, to assist with retirement planning.

While the couple's discretionary income has come down, their expenditure has also fallen, and their Living Standards Index has risen.

3.4.6 Couple Retired

The final column of figures assumes that superannuation and other savings, together with a part Age Pension generate 50% of pre-retirement earnings as income in retirement.

No income tax is assumed to be paid - a likely outcome at present, depending on the actual mix of types of payment received as retirement income.

The mortgage has been assumed to be repaid, so that housing costs have fallen to the basics – gas, water, electricity, insurance, rates, repairs and maintenance.

Even with only 50% of pre retirement gross earnings, the couple is still marginally better off in retirement in terms of relative living standards, than immediately prior to retirement.

3.5 Comments

It is appreciated that this is only one example. However, its structure brings out some relevant points:

— For most people "adequacy" of income in retirement is likely to be judged in relation to the capacity to spend immediately prior to retirement.

— People with mortgages will usually have paid them off prior to retirement – albeit sometimes utilising part of their superannuation benefits.

— Income tax after retirement is significantly less than that prior to retirement.

— Saving (whether through superannuation or otherwise) is unlikely to be affordable for those with dependent children, but could be substantial during other periods of the life cycle.

— For many "empty nesters" on middle (and higher) incomes, it will be in their own hands to determine the balance between pre and post retirement living standards.

Some further points need to be made.

The NATSEM study focuses on those in good health. Clearly, poorer health will inevitably affect living standards – both before and after retirement.

In addition, if people are faced with rising health and aged care costs which are not offset by any falling costs in other areas, then their living standards will fall.

3.6 Age Pension

It is worth noting the comparison between the "modest but adequate" living standard benchmark and the Age Pension.

	Age Pension ($)	Benchmark ($)	Age Pension / Benchmark
Couple	17,103(18,637)	19,500(21,247)	88%
Single Person	10,247(11,164)	13,260(14,448)	77%

Numbers in brackets represent those applicable at the end of 2002, consistent with changes in the level of MTAWE since 2000.

3.7 Testing Suggested Model

The approach adopted for the NATSEM study appears ideally suited to testing the results from the suggested model for future retirement incomes in section 6.

3.8 Wants and Expectations

3.8.1 Retirement Incomes

Surveys have shown that younger people – say under 40 – have generally vague expectations in retirement. Since most have focussed on gross incomes, such expectations have usually been expressed in the form of a percentage of pre-retirement gross income – say in the range of 65% - 75%. Most have also assumed that debts will have been paid off – either through regular repayments, or using part of their superannuation proceeds.

As regards "wants", financial planning promotion sometimes pictures a retirement lifestyle which is arguably significantly better than that enjoyed prior to retirement. Some pictures create an expectation of carrying on pre-retirement leisure activities and doing more of them. This in turn generates an expectation of fitness and good health, or at least an expectation that costs related any aliments will not impair their living standards, i.e. the government will provide!

It is suggested that the Superannuation system should be flexible enough to permit "wants" to be satisfied – although clearly this should not involve additional government expenditure. As regards expectations, it is arguably the government's responsibility to satisfy only "reasonable" expectations. Some further education is required to ensure that public responses to surveys will provide this.

3.8.2 Superannuation Guarantee Scheme

When the Labor government introduced the Superannuation Guarantee scheme 15 years ago, they suggested that this was necessary as funding the Age Pension out of taxation would not be a viable option in the future.

Arguably, they were successful in selling this message (as well as being correct).

It seems to be reasonably well understood though, that the SG scheme would need to be in place over the whole working lifetime in order to replace the Age Pension for most people. This could take another 30 years.

The majority of those currently working will retire well before that time. Their expectations are therefore that the Age Pension, or at least a Part Pension, will need to continue for some time yet.

This "comfort" possibly explains the extraordinary general lack of concern of super fund members over the poor investment returns over the last couple of years. (Another explanation is that the members' statements are largely incomprehensible to them, and that most do not read the investment press which has highlighted the poor returns).

3.8.3 Retirement Age

As the Prime Minister has pointed out, an "Early Retirement Cult" has developed amongst working people.

A number of factors have created this position:

— Most people consider that leisure is better than working. Early retirement will result in more time for leisure – particularly travel.

— "Down sizing" has released many older people from their jobs. Such people often have useful redundancy payments to contribute to a satisfactory early retirement lifestyle.

— Working hours have increased. Early retirement offers an opportunity for relief from the impact of "down sizing" on staff remaining.

— Obtaining employment over the age of 55 is difficult. Accessing superannuation benefits is available. Rolling over to allocated pensions will produce flexible income with low rates of tax, to facilitate the early retirement option.

— Seniors' Cards and Benefits are available from age 60. Arguably these are only minor, but anecdotal evidence suggests that they have a marginal effect in creating a desire for early retirement.

3.8.4 No Dependants

Most younger people do not expect to still have dependants when they reach retirement. Children should be self sufficient. Any indulgences for grandchildren from grandparents would be purely voluntary. Aged parents will have available sufficient resources to look after themselves in the (often modest) style of living they have been used to – government provided if necessary.

This scenario is increasingly frequently at odds with reality. Parents are having children later, and many children are not starting full time work until well into their 20's – i.e. after 4 years of tertiary education courses and overseas travel. Second marriages create second families at older ages. Widowed grandparents are moving in with the middle aged offspring – who have built the increasingly larger houses to accommodate them.

Consequently the "carefree" retirement model presented by the financial planning industry to prospective retirees is one which many people should be circumspect about. Saving now and giving up living standards to ensure a better life for dependants in your retirement may not be the most desired outcome!

3.8.5 Intergenerational Report (IGR - Appendix A)

While it may be reasonable to quibble with the Treasury assumptions in the modelling, the broad picture is not in dispute. Fundamentally, as a growing country living on the back of high fertility and immigration and growing economic benefits in the middle of the last century, we could afford to pay a major part of the benefits for those retiring out of general taxation.

As the population ages and fertility and immigration have fallen, the balance between taxation revenue and expenditure for the retired is expected to result in increasing government budget deficits, or rather that is the expectation if the current rules are not changed.

This picture confirms the Labor party rationalisation for the introduction of the Superannuation Guarantee scheme. At the same time, it notes that the current rules with regard to the provision of part Age Pensions are exceptionally generous - even for those with significant super benefits.

A possibly even bigger issue is the impact of the cost of the Pharmaceutical Benefits Scheme – both in terms of those becoming eligible for access, and also the likely increase in the range of products to improve health in retirement. Another major issue is the increasing cost of Aged Care.

The expectation is that "something must be done". Or at least this is the expectation of those who have read the IGR, or the reports on it.

Assuming increasing publicity – likely to be part of a message from all major political parties – the expectation will be that "something will be done".

4. CURRENT ISSUES

4.1 Current Position

Currently, funding of retirement incomes comes in two forms:

1) The government's Social Security Age Pension is funded from tax revenue on a pay-as-you-go basis – as are also the fringe benefits associated with payment of the Age Pension (or part of it).

2) Both the Compulsory and Voluntary Contribution elements of Superannuation Benefits are funded through private funds, with trustees relatively free to invest widely. Most funds invest some money in Government securities; however there is no compulsion. The government issued inflation linked securities some years ago; however, with low rates of inflation experienced for some years now, such investments are not considered to be a priority by fund managers.

The introduction of compulsory superannuation on this basis has resulted in a huge increase in private money invested in investment markets – from $40b in 1985 to $520b at 30 June 2002.

Such money is largely invested in equities – mainly in Australia, but with significant amounts overseas.

4.2 Future Position

Appendix A makes it clear that, without change to the current system and levels of benefits:

1) The government's expected outlay on Age Pensions is unlikely to reduce much in real terms, in spite of the introduction of the Compulsory Superannuation Guarantee (SG) scheme.

2) Any shortfall in the retirement incomes supported by the accumulation of private superannuation including SG contributions, against that "expected" according to the projections, will need to be picked up to a significant extent, by the government of the day.

4.3 Possible Solutions to Projected Budget Deficits

Possible solutions to problem (1) in 4.2 above include:

(a) raise taxation as necessary from time to time to cover budget shortfalls;

(b) increase the rate of compulsory SG contributions; and to

(c) reduce government benefits – particularly Part Pensions

(d) increase Age Pension age

The (increased) contribution rate in (b) could be reduced if measures to encourage longer workforce participation were successful.

4.4 Investment Risks

Under Defined Contribution Schemes, the investment risk is primarily borne by the members. Investment risks include possibility of benefits failing to keep pace with inflation and volatility of investment values generally.

However failure to meet expectations can also affect government expenditure – i.e. to the extent that a larger part or full Age Pension may be required.

It is generally considered that the Federal Government, through the Reserve Bank, is able to largely control the rate of inflation. This is not complete control, as international influences play a significant part in our economy. However, other countries with major economies have a similar aim, and experience over the last 15 years has demonstrated significant success in this area.

Even so, the private investment industry is wary of guaranteeing that investment returns or annuity payments will keep pace with inflation.

Yet there is likely to be a reasonable expectation in the community that, once started, pensions purchased by SG scheme benefits will keep pace with inflation – or more precisely move in line with the Age Pension.

A possible solution to this issue is for the government to compulsorily require sufficient SG benefits to be used to purchase the amount of the Age Pension on a pre-agreed pricing basis. Or, if insufficient, then the SG benefits would be utilised in purchasing a part of the Age Pension.

A major issue in this regard is the theoretical need to offer lower pensions to females than to males of the same age for the same lump sum. A possible "politically correct" solution could be for the government to allow purchase of all Age Pension amounts at a "composite" rate. This should be close to the male rate for some years having regard to the weight of money from members of each sex purchasing pensions.

A less bureaucratic approach would be for the government to simply offer annuities with guaranteed matching of payment increases to those of the Age Pension.

Retirees would be given the choice of purchasing such annuities, or forfeiting their rights to the Age Pension at a future date.

A further alternative would be for the government to make available Term Certain, nil Residual Capital Value "Annuity Bonds", with income increasing at the Age Pension increase rate, for a variety of terms, for investment by institutions or private individuals. In this way the Life Insurance industry could market individual indexed lifetime annuities, accepting the longevity risk but "re-insuring" the indexing risk to the government.

The government could go further – constraining the range and mix of superannuation fund investments during the accumulation period prior to retirement, to reduce the volatility of investment returns.

While some constraints might be considered – e.g. imposing a maximum proportion of equity style investments, in general this type of interference could impair long term investment returns for the industry. This would be to the detriment of the government when it needs to provide retirement income support via the Age Pension.

4.5 Do It Yourself (DIY) Superannuation

The concept of DIY Super was originally introduced for the wealthier members in the community. In general, the administrative costs involved – even if the current legislative and tax complexities were removed – should result in the more efficient use of retail investment vehicles by the majority of the population.

In practice, the DIY Super industry is currently expanding rapidly with many people with quite modest super benefits being persuaded to join. This has largely arisen as a result of there being greater opportunities to obtain part Age Pensions under the Social Security system, with the greater flexibility available to DIY funds. Such funds can provide "growth" complying pensions, whereas such complying pensions are not available for purchase from institutions.

This has resulted in significant costs to all concerned. There are a number of options for the government, many of which have been provided by the industry. It is to be hoped that something is done in the near future to alleviate the current farce.

4.6 Taxation

4.6.1 Tax on Contributions and Investment Income

The Superannuation industry were aghast when the Labor government introduced in 1988, a 15% tax on contributions to superannuation funds and a 15% tax on their investment earnings.

At the same time though, a 15% tax rebate on pensions derived from the funds was introduced.

The government argued that retirees would end up in the same position. All that was happening was that some of the tax ultimately payable was being brought forward.

While this argument will not apply precisely in the case of every individual, it has been broadly accepted as correct. (A relatively simple improvement to fairness and equity could be made by ensuring that the rebates on pensions carried through to cash payments where negative tax is generated).

The superannuation industry rightly complained that the introduction of taxation during the members' accumulation phase added significant extra cost. However, the bigger question is the economic one. What is the impact on the Australian Economy of levying superannuation tax earlier or later?

At the time there were valid arguments to suggest that the introduction of the tax (and its use to support government expenditure) impaired Australia's already low national savings rate. In practice the consequent advent of compulsory superannuation has halted the decline in National Savings and the position is expected to improve in the future.

As a practical point, the Intergenerational Report forecasts make it unlikely that any government could actually revert to the former position – at least not while the tax on contributions and investment income exceeds the rebate on pensions.

Further discussion on economic impacts is outside the scope of this paper.

The current position is that both major political parties are happy with the way in which the 15% tax and tax rebates operate.

Moreover from a political point of view, if there are plans to reduce Age Pension benefits to future retirees to alleviate projected Budget deficits, it would be better to maintain low rates of tax on retirement incomes in order to maximise net incomes.

4.6.2 Superannuation Surcharge

The 15% surcharge on superannuation contributions made in respect of higher earnings (currently over $90,527 p.a.), in addition to the 15% contributions tax, has become an administrative nightmare for superannuation funds.

For some funds, it is reported that the costs of administration exceed the amount of surcharge collected!

This paper does not intend to analyse this tax. However, it is suggested that if the government needs the money and/or the need to increase the progressive nature of superannuation taxes (or reduce the progressive nature of the benefits), some other method should be sought.

4.7 Access to Superannuation Benefits

4.7.1 Current Position

Currently, access to Superannuation benefits is available to those who have both (a) retired, and (b) reached the age of 55.

The minimum age is being increased by one year every two years from 2014, until it reaches age 60 in 2024.

The definition of "retirement" for this purpose has changed over the years. It currently includes a person who has left a full time employment position after the age of 60. Such a person may obtain another full time job until the age of 65, exhaust his superannuation benefits in a variety of ways including gifting to family members and improving the home, and then claim the Age Pension.

This “double-dipping” aspect causes the current Age Pension structure to be unsound.

4.7.2 Purpose

The purpose of providing access to Superannuation benefits prior to Age Pension age is to enable individuals to retire when they wish to (or perhaps forced to). At the same time, in encouraging superannuation through tax incentives, the government reasonably anticipates that an individual's super benefits would be an offset to any need for the Age Pension.

4.7.3 Superannuation Benefits as Pensions

To this end, it would be desirable for Superannuation benefits to be taken in the form of a pension - at least up to the amount of the Age Pension.
Where access is obtained at Age Pension age this provides a fair form of integration.

4.7.4 Access prior to Age Pension age

To discourage access prior to Age Pension age and effectively encourage working until at least this age, a tax penalty could apply to superannuation benefits taken prior to Age Pension age. One possibility would be for such benefits to be taxed at marginal rates as income in the year of receipt, less a 15% rebate i.e. broadly reverse the superannuation tax relief previously provided.

Alternatively (or perhaps in addition), to stop “double-dipping”, early access to superannuation benefits could be made available only to the extent that such benefits were in excess of those required to purchase or replace the Age Pension.

4.8 Investment Choice and Financial Planning

Everyone needs some income in retirement. Indeed those used to receiving regular income while working need regular income in retirement. Logically, the major part of any superannuation benefits should come in this form.

The intermediate process of investment to produce the income is of interest only to most people, in terms of the security and adequacy of the fund providing the income.

Employers, the government and the superannuation industry have colluded to transfer responsibility for the investment process from the experts (who know that at best they can only get it right over a long period) to the less expert individuals (who need to get it right for the day they retire, but don't realise that they can't do it with any degree of precision)

Currently the government is attempting to force individuals to make an investment choice, force employers to take responsibility for education in investment choice, and force financial planners to provide the advice, while keeping the costs of superannuation down!

It may help if the individuals were given a choice which they could relate to: perhaps a guarantee that contributions made will be available on retirement, together with whatever investment earnings had been achieved. That is: a capital guarantee, with a hope that investment earnings will have offset inflation (and will be better than a Retirement Savings Account).

Doubtless this would require a relatively conservative investment mix, which would produce lower projected results than those of more aggressive mixes.

But at least this could be made the "default" investment choice, requiring no advice and minimal cost. If the individual wanted investment advice with regard to other options, this could be paid for separately.

If it is decided that access to superannuation benefits is limited to Age Pension Age, death or ill health retirement, retail and wholesale products could be readily developed, with the capital guarantee only biting at this date.

4.9 Self Employed

Currently, the self employed are not required to make superannuation contributions. Full tax relief on voluntary contributions is available (subject to reasonably generous limits) which provides significant incentive. At the same time many self-employed people see the sale of their business at retirement as providing their retirement benefit, and the need to retain all cash flow to build up their business.

Many though ultimately come to rely on the Age Pension. For such people, their position is little different from most employed people at the present time.

Arguably therefore, if compulsory super is intended to largely replace the Age Pension for the majority of people, this should be extended to the self-employed.

A possible approach would be to require the self-employed to "voluntarily" contribute at least 9% of pre-super taxable earnings. The default position could then be for the ATO to levy 9% (less any voluntary contributions), and place the money in the fund for "lost" super moneys.

4.10 Ancillary Benefits

Under the current SG rules, not all of the SG contributions are required to be used to provide retirement benefits. The cost of ancillary benefits – such as death and disability benefits – can be deducted.

If the intention of the government is to look to the SG scheme to ultimately replace the Age Pension for the majority of the population, the cost of such benefits should not be deductible from SG contributions.

5. GOVERNMENT PILLAR : MOVE TO SAFETY NET

5.1 Not a New Suggestion

Many papers and submissions to government have advocated that the Age Pension should become a "safety net" to support those with inadequate income in retirement, rather than the current means tested "right". Indeed, this has been a suggested response to the increasing budget deficits forecast in the Intergenerational Report.

5.2 Dramatic Change

In practice, of all the suggested changes to Retirement Income structures, this would be arguably the most dramatic.

This is illustrated in the following example. This assumes that accumulated compulsory superannuation contributions will be used to buy at least a part Age Pension at Age Pension Age, and there are no other assets.

To the extent that Compulsory Super fails to provide the full Government Age Pension minimum (currently 26% of MTAWE for a single person), a supplementary Government Pension is payable.

	MTAWE
Compulsory Super buys private pension, say	20%
Plus	
Government Age Pension Supplement	6%
Equals	
Government Age Pension Minimum	
= Total Pension Benefits	**26%**

The above example contrasts with the current process for means testing other income. Assuming the current rules continued to apply, the benefits arising would be as follows:

		MTAWE
Compulsory Super buys private pension, say		20%
Plus		
Part Government Age Pension,		
i.e. Government Age Pension	26%	
Less		
40% of Excess* Other Income		
i.e. 40% x (20% - 7%)	(5%)	
Part Government Age Pension		21%
Total Pension Benefits		**41%**

* Means Test Threshold approximately 7% MTAWE

5.3 Transitional Implementation

Introduction of the safety net concept along the above lines would clearly reduce government expenditure. At the same time the outcome in $ terms would be significantly less than that currently reasonably expected by the working population.

However, clearly with such a negative impact on expectations, any move to the "safety act" concept would need to be phased in over a long period – possibly only fully reaching this position after a full working life of say 45 years.

It is envisaged that a package of measures would need to be introduced to facilitate such a change, for example:

(i) Require separate member accounts within each superannuation fund for compulsory and other contributions, from the commencement of the new measures.

(ii) Require the compulsory contributions account balance to be used first, to purchase a pension at Age Pension age up to the full age pension.

(iii) Require the pension in (ii) to be for life and to keep pace with increases in MTAWE – purchase from the government, (at same composite rate for males and females), or purchase from a life office which may invest in new government issued Term Certain MTAWE linked Annuity Bonds.

(iv) Apply means test rules only to that part of the Age Pension not purchased.

(v) Allow all voluntary superannuation contributions to be tax deductible.

These measures could be introduced more or less immediately as the impact affects only future contributions (and hence provides some necessary transitional arrangement).

At the present time, those pensioners with no means other than the Age Pension receive a range of basic supplementary benefits, as well as the fringe benefits available to all pensioners.

The logic of the "safety net" concept demands setting the Age Pension at a level which can eliminate the need for such benefits. Reference to Section 3 of this paper suggests adoption of the "safety net" Age Pension at the level which would support the "modest but adequate" living standards. For a couple this is $21,247 (in 2002 $) or 49% MTAWE; for a single person this is $14,448 or 34% MTAWE.

(Arguably the "safety net" should be even higher – i.e. to accommodate the "basic" housing costs. These were $2,500 pa for home owners without a mortgage in 2000, or 6% of MTAWE. On the other hand, the current means test free income allowance of about 7% MTAWE, may continue).

These numbers are significantly higher than those for the current Age Pension - $18,637 for couples and $11,164 for singles respectively. An immediate increase in the Age Pension to the "modest but adequate" living standard levels, while maintaining the other aspects of the social security and means test system is not practical.

Accordingly, for the purpose of the examples below, it is assumed that the higher levels of Age Pension will only be introduced in the latter part of the next 45 years.

5.4 Examples

5.4.1 Assumptions

The following examples are based on the following assumptions:

Investment Earnings (after investment management fees)	6% p.a. gross, 5.1% p.a., after tax
Fund Membership Expenses	$312 p.a., increasing in line with CPI at 3% p.a.
Growth in Personal Earnings	4% p.a.
Cost of Age Pension in 2002	Approximately $135,000 for single person
Age Pension for single person owning home	26% MTAWE (Male ordinary Time Average Weekly Earnings), increasing to 34% under "Safety Net" concept

All numbers are converted to pensions as % MTAWE at above rate, increasing in line with MTAWE, with no tax on the lump sums used for this purpose.

Current rules in relation to the means test include:

— maximum exempt income of 7% MTAWE, with 40% of excess used to reduce the amount of the Age Pension payable. These are assumed to continue in real terms.

Compulsory superannuation benefits utilised first to purchase Age Pension to the extent possible. Any balance of Age Pension required paid as "safety net" supplement.

Future compulsory super (SG) contributions for a person currently earning $43,000 p.a. will accumulate to $31,000 after 10 years, $66,000 after 20 years, and $173,000 after 45 years, in 2002 standard of living terms.

5.4.2 Results

Detailed calculations are set out in Appendix B.

A summary of the results is as follows:

	Current Rules	**"Safety Net" Model**
Single Person retiring on $125,000		
Today	44%	44%
In 10 years' time	44%	41%
In 20 years' time	44%	38%
In 45 years' time	44%	34%
Single Person retiring on $173,000		
Today	49%	49%
In 10 years' time	49%	45%
In 20 years' time	49%	41%
In 45 years' time	49%	34%
Single Person retiring on $268,000		
Today	59%	59%
In 10 years' time	59%	55%
In 20 years' time	59%	52%
In 45 years' time	59%	52%

5.4.3 Comments

(1) Ultimately, the "Safety Net" approach will produce significantly lower outcomes compared with those at present (apart from the very poor and the higher earners). This is to be expected when the Age Pension moves from being a means tested "right", for around 90% of the population, to being a "safety net" for a minority.

(2) The richer ($268,000) person appears to be less harshly treated than his less rich $173,000 counterpart (and indeed his "poorer" $125,000 relation). In practice the $268,000 person is providing most of the benefits from accumulated Superannuation Contributions in all scenarios.

5.5 Use in Suggested Model

The above move to the "Safety Net" approach for the Age Pension is incorporated in the suggested model in Section 6.

6. A SUGGESTED MODEL

6.1 Introduction

The earlier parts of this paper:

(i) noted the generally accepted 3 "pillars" of the financial structure supporting retirees;

(ii) noted the significant range of circumstances of individuals and their attitudes towards retirement;

(iii) addressed the question of "adequacy" of retirement incomes; and

(iv) drew attention to current issues, focussing particularly on Social Security system anomalies and the potential problems of the modern "early retirement cult".

The paper has also noted that the Federal Government's Intergenerational Report last year forecast increasing budget deficits in the future from the ageing of the population.

A number of groups have suggested moving the Age Pension to a "safety net" for a minority, from its current "right" for all subject to a means test. This paper supports that approach and suggests a methodology for making it happen.

The "suggested model" in this section of the paper attempts to incorporate "solutions" to the issues identified in earlier sections.

6.2 Integration of Superannuation and Social Security Benefits

The following suggested model incorporates a certain approach to integration. A general assumption is made that most of the current anomalies are eliminated as part of the "implementation" of the model. A separate paper covering integration in greater detail has been prepared for the Convention. This sets out suggestions for the elimination of anomalies.

Other specific assumptions are (i) that the concept of an Age Pension age will continue – currently age 65 for males and 62 for females, transitioning to 65 by 2014 (although increasing longevity may justify increasing this age from time to time in the future);, and (ii) an "incomes" test only will apply, with all assets deemed to earn income at specified rates, or if not specified then at the "ELC pension rate" – see below.

6.3 Earnings Linked Complying Pension (ELC Pension)

To facilitate integration and financial planning generally, complying lifetime pensions with payments indexed to MTAWE will be assumed to be made available.

The government could make such "Earnings Linked Complying Pensions" available for purchase by individuals directly from the government. Under this approach the government accepts the longevity risk. Alternatively the government could issue Term Certain, nil Residual Value Annuity Bonds, for purchase by Life Companies which would then underwrite the longevity risk, but would be immunised against the inflation risk.

6.4 Main Features of Suggested Model

6.4.1 Compulsory Superannuation Used to Buy Age Pension

Benefits arising from the investment of Compulsory Superannuation (Superannuation Guarantee) contributions are utilised first to purchase an ELC pension equal to the Age Pension. If insufficient, the whole of the benefits are utilised to purchase an ELC Pension equal to a Part Pension.

For defined benefit schemes an amount equal to the accumulation of notional SG contributions at the fund's earning rate would be made available on retirement for this purpose.

6.4.2 Age Pension as "Safety Net"

Ultimately, the Age Pension is moved from being a "right" subject to means test, to being a "safety net" for a minority. When this move is made, the amount of the Age Pension is increased to the level necessary to provide a "modest but adequate" living standard.

Adoption of such a standard in accordance with the NATSEM 2001 study of Budget Standards for CPA Australia and Tower Financial Services would increase the Age Pension as follows:

	Current	Suggested
Single Person	26%	34%
Couple	43%	49%

6.4.3 Access to Superannuation Benefits from Age Pension Age

Access to Superannuation Benefits is available normally only from Age Pension age. Earlier access is permitted only where benefits are first utilised to purchase the full Age Pension from Age Pension age.

6.4.4 15% Superannuation Tax/Tax Relief to Continue

The 15% tax on superannuation contributions and investment income during the accumulation phase continues. Consistent with this, the 15% tax relief on pension benefits payable from the accumulation of taxed contributions also continues.

Where the rebate generates "negative" tax, this will be paid to the individual.

6.4.5 Minimum Private Pension is ELC Pension

The minimum pension that may be taken as an allocated pension or a complying pension is equal to the ELC Pension at the person's age at date of purchase, indexed to the date of payment.

6.4.6 Marginal Tax Rates applied to Lump Sum Benefits

Where a lump sum benefit is taken from a Superannuation Fund, tax is payable at the individual's marginal tax rate(s). If the benefit is payable from taxed superannuation proceeds, the 15% rebate will apply.

6.4.7 Reasonable Benefits Limits to Equal Pensions RBL

A single RBL will apply – equal to the current Pensions RBL. This will be stated as the maximum amount payable from all superannuation funds prior to Age Pension age. Any excess taken (or not taken at Age Pension age) will be taxed at the individual's top marginal rate.

6.4.8 All Voluntary Contributions Tax Deductible

All voluntary contributions to Superannuation Funds are tax deductible. There is no need for any limits, as any excess benefits over the RBL will be taxed at the individual's top marginal tax rate.

6.4.9 Reduced Age Pension Reduction for those Working Beyond Age Pension Age

Earnings from personal exertion up to 10% MTAWE are ignored. Thereafter the income test reduction for such earnings from personal exertion is changed to 20% of such earnings, compared with the current 40% (which will continue to apply to investment and superannuation income)

6.5 Transitional Arrangements

Implementation of any changes to Superannuation or Social Security rules requires attention to the positions of those who are affected negatively by the change.

At the first level of concern is the need to ensure that, as far as possible, entitlements that have accrued up to the date of change are maintained. This arises particularly in the case of Superannuation where contributions have been made on a certain basis and with certain expectations with regard to the benefits that have effectively been "bought" by such contributions. Maintenance of such accrued entitlements usually is considered to extend to their taxation.

Such issues tend not to exist for Social Security Benefits. These are paid for out of taxation and there are no clear accrued entitlements. However, there are "reasonable expectations".

Any person currently receiving the Age Pension or a Part Pension according to current rules "expects" this position to be maintained in real terms – if not actually improved. In general, governments have tended to consider that such an expectation is reasonable – even if the current position is anomalous in some way. This is partly because change is likely to be administratively difficult and confusing for older people.

Of less concern to governments are the expectations of those who have not reached Age Pension age. Even so, there is an appreciation that those who are close would have made plans based on the current rules and will have limited opportunity to make changes.

It is assumed that such considerations will be applied in the implementation of any new model. The following suggestions incorporate this approach.

6.5.1 Compulsory Superannuation Used to Buy Age Pension

Currently there are no differences in treatment between benefits arising from compulsory contributions and other contributions.

Accordingly, the "compulsion" to utilise benefits arising from compulsory super contributions should only apply to future contributions. To facilitate this, superannuation funds would be required to establish a separate account for such contributions and accruing benefits.

It would also be necessary for there to be no charges for ancillary benefits deducted from the "SG account".

6.5.2 Age Pension as "Safety Net"

It will clearly take many years – perhaps close to a whole generation – for compulsory super benefits to be sufficient to purchase the full Age Pension for the majority of the population.

However, some phasing out of the current means test will occur automatically through implementation of the suggested model in section 6.4. Under this suggestion, the means test rules will apply only to the entitlement to that part of the Age Pension not purchased by the compulsory contributions.

At the same time, there will still be a need to actually make the final move to the target position where:

(i) a supplementary Age Pension is paid to bring the pension purchased by compulsory contributions up to the full Age Pension; and

(ii) the amount of the Age Pension is increased to the level required to support "modest but adequate" living standards – e.g. based on Section 3 of this paper, for an individual living in their own home without a mortgage, from 26% to 34% MTAWE, and from 43% to 49% MTAWE for couples.

Such changes are clearly desirable from the point of view that government expenditure is better targeted. However, the Supplementary Pension will be effectively a "gift" which would destroy any incentive for the individual to continue to work even on a part time basis – unless earnings from such employment were exempted – at least in part.

The timing of such moves will need to be carefully considered in the context of announcements foreshadowing them and budgetary considerations generally.

6.5.3 Access to Superannuation Benefits from Age Pension Age

The current minimum access age is 55. To move this to age 65 within a short period would upset the plans of many people close to retirement. A compromise is called for.

It is suggested that people currently under the age of 50 should be considered as having sufficient time to change their plans. This implies that, if the change were announced this year it would not be fully effective until 2019. The transition could be presented as follows:

Age in 2003	Age for Access to Super	Year for Access to Super
49	65	2019
50	63	2014
51	61	2011
52	59	2008
53	57	2006
54	55	2004

This transition schedule would replace that currently planned to move the minimum access age to age 60 by 2014. This is clearly too long a transition period to eliminate “double dipping” anomalies and to reverse the “early retirement cult”.

6.5.4 Minimum Private Pension is ELC Pension

This change is suggested in order to “correct” the current over generous tax and Social Security treatment of allocated and complying pension benefits. Accordingly, it should apply as soon as possible for new pensions. Inevitably though there will need to be a short transition period for education purposes, and arguably this should apply to avoid upset to plans for those close to retirement.

6.5.5 Marginal Tax Rates Applied to Lump Sum Benefits – Reasonable Benefits Limits to Equal Pensions RBL

These need to be introduced at the same time. They could be brought in more or less immediately for those whose total superannuation benefits are "Post 1983". A 2 year notification and education period would seem appropriate.

For those with Pre 1983 benefits, the continuation of the current transition rules would seem to be necessary.

6.5.6 All Voluntary Contributions Tax Deductible

This is a simple change, and would encourage superannuation investment and savings generally. It would also eliminate the need for salary sacrifice arrangements and potential concern that insufficient compulsory contributions were being paid (i.e. on net salary).

Accordingly, immediate implementation is suggested.

6.5.7 Reduced Age Pension Reduction for Those Working Beyond Age Pension Age

This encourages the right behaviors and the net cost to the government revenue should be small and short lived. Immediate implementation is suggested.

6.6 Education and Encouragement

Implementation of any new model would require attention to other aspects of retirement policy which need to be put in place. These include particularly education/promotion and encouragement of both employers and employees towards working beyond Age Pension age.

The suggested model includes encouragement through the superannuation tax and social security systems. It also withdraws some of the current encouragements to retiring early. However employment practices (and maybe laws) need to change to encourage greater worker participation at older ages.

6.7 Examples

The following examples illustrate the effect of the suggested model features. They also provide the opportunity to illustrate other aspects of the model.

The format picks up the theme of the paper – Adequacy of Retirement Incomes – and expresses the results in the Section 3 format – i.e. comparing living standards pre and post retirement.

For this purpose the same costs of a "modest but adequate" standard of living will be assumed to continue to apply in real terms, and are expressed as percentages of MTAWE, i.e.

	2002 $	**%MTAWE**
Home owners with no dependents		
- couples	21,247	49%
- singles	14,448	34%
Cost of children		
- aged 5-12	7,367	17%
- aged 13-16	8,215	19%
Cost of Working	1,133	2.6%
Costs of Housing		
- basic plus paying off mortgage	15,690	37%
- basic only	2,724	6%

The annuity factor adopted in all cases at age 65 to convert lump sums to MTAWE linked pensions, is that applicable to a male aged 20 today using the Australian Life Tables 95-97, allowing for improvement to longevity, i.e. 0.08282.

6.7.1 Middle Income Couple

This example considers the position of the middle income couple in Section 3, in the future.

The couple will be assumed to be able to afford to pay voluntary contributions of 10% of earnings in the last 10 years of their working life.

Forecast retirement income comparison after 45 years is as follows:

	Current Rules (% MTAWE)	Suggested Model (%MTAWE)
1st Partner		
- Compulsory Super buys	33%	33%
- Voluntary Contributions buys	7%	7%
2nd Partner		
- Compulsory Super buys	24%	24%
- Voluntary Contributions buys	6%	6%
Total		
- Compulsory Super buys	57%	57%
- Voluntary Contributions buys	13%	13%
- Age Pension	43%	Supplement 0%
Less Means Test Adjustment (70-7) x .4 =	(25%)	0%
Total Couple Gross Income	**88%**	**70%**

Forecast cash flow position, relative to "modest but adequate" living standard is as follows:

	Couple with Dependent children (%MTAWE)	Couple as "empty nesters" (%MTAWE)	Couple Retired	
			Current Rules (%MTAWE)	Suggested Model (%MTAWE)
Gross Income				
- Earnings	175%	175%	0%	0%
- Pensions	0%	0%	88%	70%
- Income Support	5%	0%	0%	0%
Total Gross Income	**180%**	**175%**	**88%**	**70%**
Less				
- Income Tax	38%	33%	0%	(10%)
- Voluntary Super Contributions	0%	18%	0%	0%
- Housing Costs	37%	37%	6%	6%
"Discretionary" Income	**105%**	**87%**	**82%**	**74%**
"Modest but adequate" living standard benchmarks				
- Cost of 2 adults	49%	49%	49%	49%
- Cost of 2 working	5%	5%	0%	0%
- Cost of 2 children	36%	0%	0%	0%
Benchmark	**90%**	**54%**	**49%**	**49%**
Living Standards Index =				
Discretionary Income Benchmark	**1.17**	**1.61**	**1.67**	**1.51**

Conclusions for this couple in this situation on the basis of this model are:

(i) The current rules result in exceeding reasonable expectations in retirement

(ii) The suggested model provides a significantly better living standard than the "modest but adequate" benchmark, but is likely to fall short of the couple's expectations based on their immediate pre-retirement standard of living.

(iii) An increase in the rate of SG contributions from 9% to 10% of earnings would be one way of meeting expectations.

(iv) The proposed extension of the benefit of the 15% rebate to be paid even where this generates negative tax, provides significant support for this couple in retirement under the suggested model.

6.7.2 Other Examples

Calculations for other examples have been carried out and are set out in Appendix C. These include the results of additional calculations assuming the rate of SG contributions are increased to 10% of earnings.

6.7.3 Summary of Results

A summary of the results of all the examples is as follows:

Example % MTAWE)	Living Standards Index				
	Dependent Children	Empty Nesters	Retired		
			Current Rules 9% SG Contributions	Suggested Model SG Contributions	
				9%	10%
Couple					
- 100%/75%	1.17	**1.61**	1.67	1.51	**1.63**
- 150%/100%	1.63	**2.43**	2.08	2.04	**2.20**
- 75%/50%	0.78	**1.04**	1.41	1.20	**1.22**
Single					
- 100%		**1.22**	1.44	1.21	**1.29**
- 150%		**2.00**	1.76	1.71	**1.82**
- 75%		**0.78**	1.26	1.18	**1.18**

Overall conclusions are:

(i) The current rules are over generous for middle and lower income people;

(ii) The current level of 9% of earnings SG contributions is inadequate to meet the expectations of the middle and higher income people;

(iii) An increase in the level of SG contributions from 9% to 10% of earnings would provide a broadly satisfactory result for the middle income people in the examples;

(iv) The increase to 10% SG contributions for the lower paid single person doesn't actually generate any extra benefit, and only a marginal extra benefit for the low paid couple. This is because, as a "safety net" the Age Pension supplement is simply reduced by the additional compulsory superannuation pension achieved.

(v) Higher paid people have the ability to save more while they are working if they wish to have a larger income in retirement. For example, an increase in the voluntary contribution rate from 10% to 14% of earnings in the 10 years prior to retirement would result in a post retirement living standards index equivalent to that for these people as "empty nesters".

(vi) A higher SG contribution increase than that from 9% to 10% could be justified as ensuring the meeting of the needs of a broader range of people in retirement – those with fluctuating earnings, those with dual family commitments, as well as the higher earners. However, the government's responsibility arguably only extends to ensuring an adequate standard of living for all in retirement. 10% of earnings and the "Safety Net" Age Pension should do this.

6.7.4 Highly Paid People

Numbers were calculated on the above bases for those on incomes in excess of the "higher income" people in the examples. However, they served only to emphasize the point made in 6.7 (v) above with regard to their flexibility to "balance" their pre and post retirement standards of living.

It is possible also that the relationship between the expenditure needs of the highly paid and the suggested "Budget Standard" items in the NATSEM study is too far apart for the numbers to be relevant.

6.8 Sensitivity to Economic Assumptions

The results of the model test are highly sensitive to the economic assumptions. Simply assuming a 7% p.a. long term investment return instead of 6% p.a. with no change to other assumptions, would produce results which suggest that the 9% of earnings SG contribution rate would be adequate. On the other hand a reduction to 5% p.a. would suggest that 12% of earnings was required.

6.9 Financial Planning

The examples are at best only broadly representative of the population earning between 75% and 150% of MTAWE Even with an increase in the SG rate to 10% of earnings and other model assumptions, adequacy will only be achieved by those retiring at age 65 in 2047 and beyond. Even for these people, those with fluctuating patterns of earnings or broken periods of work, or multiple partners with children, or unable to voluntarily contribute 10% of earnings in the last 10 years of their working life, or are renting or still paying off a mortgage in retirement, will not necessarily find that their results will meet their expectations.

These are not arguments for not increasing the SG contributions. They are simply recognising that the "one size fits all" approach to planning for retirement cannot work. Flexibility is called for.

The 10% level of SG contributions must be sold as the minimum to achieve adequacy of income in retirement. Some additional saving will be needed to meet the expectations of most people – particularly those who wish to retire prior to Age Pension age. This is where the flexibility can be applied. The government provides the frame work for encouraging such saving – i.e. tax relief for voluntary contributions. But it will be up to the individual to decide whether to make such contributions.

Good financial planning will be required. At the same time, it is suggested that the financial planning is carried out along the lines of that utilised in developing the above examples.

It would also be of enormous assistance to all parties if the tax and social security integration rules were simplified for retirees. These issues are being addressed in the "Integration" paper being presented at this Convention.

6.9 Investment Risk

The suggested model puts an increased focus on the potential volatility of lump sum benefits purchased by defined contributions and invested largely in equity markets.

Moreover, unlike allocated pensions, the pensions purchased to replace the Age Pension will not benefit from future investment market returns.

Consequently, investment strategies developed by financial planners will need to take into account client attitudes towards potential volatility in lump sum benefit values close to age 65.

In this regard it would be helpful if the funds management industry (supported by their actuarial advisers) could develop suitable products to meet the objectives of those that wish to minimise this volatility.

7. WORKING TOWARDS A BETTER STRUCTURE

It is suggested that the Institute consider further development of the issues in this paper and the Integration paper presented to this Convention.

Steps required include:

— Develop Principles intended to receive bipartisan support for a long term retirement incomes system.

— Test models which are consistent with these Principles, including the model suggested in this paper.

— Carry out forecasts of the impact of possible models on government budgets and the economy generally.

— Prepare suitable paper for submission to Senate Select Committee, Federal Government and Opposition.

APPENDIX A – INTERGENERATION REPORT FORECASTS

The following numbers are taken from the Intergenerational Report, published in May 2002. They show the forecast outflows and deficits which would apply assuming no changes to current social security rules, other than adjusting pension and other social security payments in line with CPI.

For relevant comparison with regard to the significance for the growing Australian economy, numbers are expressed as percentages of Gross National Product (GNP). Overall taxation is assumed to increase in line with GNP.

Tax Year	Expenditure on			Aggregate Federal Government Budget Surplus/ (Deficit)%GNP
	Age and Service Pensions %GNP	Pharmaceutical Benefits Scheme %GNP	Aged Care $GNP	
2001 / 02	2.9	0.6	0.7	0.1
.				
.				
2006 / 07	2.8	0.6	0.8	0.9
.				
.				
2011 / 12	2.9	0.8	0.8	0.7
.				
.				
2021 / 22	3.6	1.3	1.0	(0.8)
.				
.				
2031 / 32	4.3	2.1	1.4	(3.0)
.				
.				
2041 / 42	4.6	3.4	1.8	(5.0)
.				
.				

APPENDIX B – MOVE TO "SAFETY NET" - EXAMPLES

Examples of Ultimate Retirement Incomes (%'s shown are of MTAWE) (Refer Section 5 of paper)

Single person retiring in 45 years' time with Lump Sum $125,000, all accumulated SG contributions.

Current Rules		Suggested Move to Safety Net (34% MTAWE)	
$125,000 can buy Private Pension	24%	$125,000 Buys	24%
Age Pension	26%	Age Pension	
Less (24-7) x .4	(7%)	Supplement	10%
Total	43%		34%

Single person retiring in 45 years' time with Lump Sum $173,000, all accumulated SG contributions.

Current Rules		Suggested Move to Safety Net (34% MTAWE)	
$173,000 can buy Private Pension	33%	$173,000 buys	33%
Age Pension	26%	Age Pension	
Less (33-7) x .4	(10%)	Supplement	1%
Total	49%		34%

Single person retiring in 45 years' time with Lump Sum $268,000, all accumulated SG contributions.

Current Rules		Suggested Move to Safety Net (34% MTAWE)	
$268,000 can buy Private Pension	52%	$268,000 buys	52%
Age Pension	26%	Age Pension	
		Supplement	0%
Less (52-7) x .4	(18%)		
Total	60%		52%

Intermediate Period Examples

Single person retiring in 10 years' time with $125,000, including accumulated SG contributions of $23,000

Current Rules		Suggested Move to Safety Net (26% MTAWE)	
$125,000 can buy Private Pension	24%	$23,000 of SG contributions Buys	4%
Age Pension	26%	$102,000 of voluntary contributions	
Less (24-7) x .4	(7%)	Buys	20%
		Balance of Age Pension	22%
		Less (20-7) x .4	(5%)
Total	43%		41%

Single person retiring in 10 years' time with $173,000, including accumulated SG contributions of $31,000

Current Rules		Suggested Move to Safety Net (26% MTAWE)	
$173,000 can buy Private Pension	33%	$31,000 of SG contributions Buys	6%
Age Pension	26%	$142,000 of voluntary contributions	
Less (33-7) x .4	(10%)	Buys	27%
		Balance of Age Pension	20%
		Less (27-7) x .4	(8%)
Total	49%		45%

Single person retiring in 10 years' time with $268,000, including accumulated SG contributions of $47,000

Current Rules		Suggested Move to Safety Net (26% MTAWE)	
$268,000 can buy Private Pension	52%	$49,000 of SG contributions Buys	9.4%
Age Pension	26%	$219,000 of voluntary contributions	
Less (52-7) x .4	(18%)	buys	42.2%
		Balance of Age Pension	17%
		Less (42 -7) x .4	(14%)
Total	60%		55%

Intermediate Period Examples

Single person retiring in 20 years' time with $125,000, including SG contributions of $48,000

Current Rules		Suggested Move to Safety Net (26% MTAWE)	
$125,000 can buy Private Pension	24%	$48,000 of SG contributions Buys	9%
Age Pension	26%	$77,000 of voluntary contributions	
Less (24-7) x .4	(7%)	Buys	15%
		Balance of Age Pension	17%
		Less (15 -7) x .4	(3%)
Total	43%		38%

Single person retiring in 20 years' time with $173,000, including accumulated SG contributions of $66,000

Current Rules		Suggested Move to Safety Net (26% MTAWE)	
$173,000 can buy Private Pension	33%	$66,000 of SG contributions Buys	13%
Age Pension	26%	$107,000 of voluntary contributions	
Less (33-7) x .4	(10%)	Buys	20%
		Balance of Age Pension	13%
		Less (20 -7) x .4	(5%)
Total	49%		41%

Single person retiring in 20 years' time with $268,000, including accumulated SG contributions of $103,000

Current Rules		Suggested Move to Safety Net (26% MTAWE)	
$268,000 can buy Private Pension	52%	$103,000 of SG contributions Buys	20%
Age Pension	26%	$165,000 of voluntary contributions	
Less (52-7) x .4	(18%)	Buys	32%
		Balance of Age Pension	6%
		Less (32-7) x .4	(6%)
Total	60%		52%

APPENDIX C – SUGGESTED MODEL - EXAMPLES

Retirement Incomes Outcomes

This appendix contains the full set of detailed calculations for the examples in Section 6 – A Suggested Model.

For each example, the "modest but adequate" standard of living benchmarks from NATSEM study in Section 3 will be assumed to apply. They will be assumed to increase in real terms and can therefore be expressed as percentages of MTAWE i.e.

	2002 $	%MTAWE
Home owners with no dependents		
- couples	21,247	49%
- singles	14,448	34%
Cost of children		
- aged 5-12	7,367	17%
- aged 13-16	8,215	19%
Cost of Working	1,133	2.6%
Costs of Housing		
- basic plus paying off mortgage	15,690	37%
- basic only	2,724	6%

The annuity factor adopted in all cases at age 65 to convert lump sums to MTAWE linked pensions, is that applicable to a male aged 20 today using the Australian Life Tables 95-97, allowing for improvement to longevity, i.e. 0.08282. (Numbers need to be recalculated)

Separate results are shown for 9% and 10% of earnings Compulsory Super (SG) contributions.

In each case it is assumed that voluntary contributions of 10% of earnings will be made during the last 10 years of working life.

Middle Income Couple

Forecast retirement income comparison after 45 years is as follows (%MTAWE):

	Current Rules 9% SG Contributions	Suggested Model 9% SG Contributions	Suggested Model 10% SG Contributions
1st Partner (earning 100% MTAWE)			
- Compulsory Super buys	33%	33%	37%
- Voluntary Contributions buys	7%	7%	7%
2nd Partner (earning 75% MTAWE)			
- Compulsory Super buys	24%	24%	27%
- Voluntary Contributions buys	6%	6%	6%
Total			
- Compulsory Super buys	57%	57%	64%
- Voluntary Contributions buys	13%	13%	13%
- Age Pension	43%	Supplement	Supplement
Less Means Test Adjustment (70-7) x .4 =	(25%)	0%	0%
Total Couple Gross Income	**88%**	**70%**	**77%**

Forecast cash flow position, relative to "modest but adequate" living standard is as follows:

	Couple with Dependent children (%MTAWE)	Couple as "empty nesters" (%MTAWE)	Couple Retired (% MTAWE) Current Rules 9% SG Contributions	Couple Retired (% MTAWE) Suggested Model 9% SG Contributions	Couple Retired (% MTAWE) Suggested Model 10% SG Contributions
Gross Income					
- Earnings	175%	175%	0%	0%	0%
- Pensions	0%	0%	88%	70%	77%
- Income Support	5%	0%	0%	0%	0%
Total Gross Income	**180%**	**175%**	**88%**	**70%**	**77%**
Less					
- Income Tax	38%	33%	0%	(10%)	(9%)
- Voluntary Super Contributions	0%	18%	0%	0%	0%
- Housing Costs	37%	37%	6%	6%	6%
"Discretionary" Income	**105%**	**87%**	**82%**	**74%**	**80%**
"Modest but adequate" living standard					
- Cost of 2 adults	49%	49%	49%	49%	49%
- Cost of 2 working	5%	5%	0%	0%	0%
- Cost of 2 children	36%	0%	0%	0%	0%
Benchmark	**90%**	**54%**	**49%**	**49%**	**49%**
Living Standards Index = Discretionary Income / Benchmark	**1.17**	**1.61**	**1.67**	**1.51**	**1.63**

Higher Income Couple

Forecast retirement income comparison after 45 years is as follows (% MTAWE):

	Current Rules 9% SG Contributions	Suggested Model	
		9% SG Contributions	10% SG Contributions
1st Partner (earning 150% MTAWE)			
- Compulsory Super buys	52%	52%	58%
- Voluntary Contributions buys	11%	11%	11%
2nd Partner (earning 100% MTAWE)			
- Compulsory Super buys	33%	33%	37%
- Voluntary Contributions buys	7%	7%	7%
Total			
- Compulsory Super buys	85%	85%	95%
- Voluntary Contributions buys	18%	18%	18%
- Age Pension	43%	Supplement 0%	Supplement 0%
Less Means Test Adjustment (103-7) x .4 =	(38%)	0%	0%
Total Couple Gross Income	**108%**	**103%**	**113%**

Forecast cash flow position at various stages of life cycle relative to "modest but adequate" living standard is as follows:

	Couple with Dependent children (%MTAWE)	Couple as "empty nesters" (%MTAWE)	Couple Retired (% MTAWE)		
			Current Rules 9% SG Contributions	Suggested Model	
				9% SG Contributions	10% SG Contributions
Gross Income					
- Earnings	250%	250%	0%	0%	0%
- Pensions	0%	0%	108%	103%	113%
- Income Support	0%	0%	0%	0%	0%
Total Gross Income	**250%**	**250%**	**108%**	**103%**	**113%**
Less					
- Income Tax	66%	57%	0%	(3%)	(1%)
- Voluntary Super Contributions	0%	25%	0%	0%	0%
- Housing Costs	37%	37%	6%	6%	6%
"Discretionary" Income	**147%**	**131%**	**102%**	**9100%**	**108%**
"Modest but adequate" living standard					
- Cost of 2 adults	49%	49%	49%	49%	49%
- Cost of 2 working	5%	5%	0%	0%	0%
- Cost of 2 children	36%	0%	0%	0%	0%
Benchmark	**90%**	**54%**	**49%**	**49%**	**49%**
Living Standards Index = Discretionary Income / Benchmark	**1.63**	**2.43**	**2.08**	**2.04**	**2.20**

Lower Income Couple

Forecast retirement income comparison after 45 years is as follows (% MTAWE):

	Current Rules 9% SG Contributions	Suggested Model	
		9% SG Contributions	10% SG Contributions
1st Partner (earning 75% MTAWE)			
- Compulsory Super buys	24%	24%	27%
- Voluntary Contributions buys	6%	6%	6%
2nd Partner (earning 50% MTAWE)			
- Compulsory Super buys	15%	15%	17%
- Voluntary Contributions buys	4%	4%	4%
Total			
- Compulsory Super buys	39%	39%	44%
- Voluntary Contributions buys	10%	10%	10%
- Age Pension	43%	Supplement 10%	Supplement 5%
Less Means Test Adjustment	(49-7) x .4 =(17%)	(10-7) x .4 =(1%)	(10-7) x .4 =(1%)
Total Couple Gross Income	**75%**	**58%**	**58%**

Forecast cash flow position at various stages of life cycle relative to "modest but adequate" living standard is as follows:

	Couple with Dependent children (%MTAWE)	Couple as "empty nesters" (%MTAWE)	Couple Retired (% MTAWE)		
			Current Rules 9% SG Contributions	Suggested Model	
				9% SG Contributions	10% SG Contributions
Gross Income					
- Earnings	125%	125%	0%	0%	0%
- Pensions	0%	0%	75%	58%	58%
- Income Support	5%	0%	0%	0%	0%
Total Gross Income	**130%**	**125%**	**75%**	**58%**	**58%**
Less					
- Income Tax	23%	19%	0%	(7%)	(8%)
- Voluntary Super Contributions	0%	13%	0%	0%	0%
- Housing Costs	37%	37%	6%	6%	6%
"Discretionary" Income	**70%**	**56%**	**69%**	**59%**	**60%**
"Modest but adequate" living standard					
- Cost of 2 adults	49%	49%	49%	49%	49%
- Cost of 2 working	5%	5%	0%	0%	0%
- Cost of 2 children	36%	0%	0%	0%	0%
Benchmark	**90%**	**54%**	**49%**	**49%**	**49%**
Living Standards Index = Discretionary Income / Benchmark	**0.78**	**1.04**	**1.41**	**1.20**	**1.22**

Middle Income Single

Forecast retirement income comparison after 45 years is as follows (% MTAWE):

	Current Rules 9% SG Contributions	Suggested Model	
		9% SG Contributions	10% SG Contributions
Earnings 100% MTAWE			
- Compulsory Super buys	33%	33%	37%
- Voluntary Contributions buys	7%	7%	7%
- Age Pension	26%	Supplement 1%	Supplement 0%
Less Means Test Adjustment	(40-7) x .4 = (13%)	(7-7) x.4 = 0	0%
Total Couple Gross Income	**53%**	**41%**	**44%**

Forecast cash flow position at various stages of life cycle relative to “modest but adequate” living standard is as follows:

	Single in workforce (%MTAWE)	Single Retired (% MTAWE)		
		Current Rules 9% SG Contributions	Suggested Model	
			9% SG Contributions	10% SG Contributions
Gross Income				
- Earnings	100%	0%	0%	0%
- Pensions	0%	53%	41%	44%
- Income Support	0%	0%	0%	0%
Total Gross Income	**100%**	**53%**	**41%**	**44%**
Less				
- Income Tax	20%	0%	(4%)	(4%)
- Voluntary Super Contributions	10%	0%	0%	0%
- Housing Costs	25%	4%	4%	4%
“Discretionary” Income	**45%**	**49%**	**41%**	**44%**
“Modest but adequate” living standard benchmarks				
- Cost of 1 adult	34%	34%	34%	34%
- Cost of working	3%	0%	0%	0%
Benchmark	**37%**	**34%**	**34%**	**34%**
Living Standards Index = Discretionary Income / Benchmark	**1.22**	**1.44**	**1.21**	**1.29**

Higher Income Single

Forecast retirement income comparison after 45 years is as follows ($ MTAWE):

	Current Rules 9% SG Contributions	Suggested Model 9% SG Contributions	Suggested Model 10% SG Contributions
Earnings 150% MTAWE			
- Compulsory Super buys	52%	52%	58%
- Voluntary Contributions buys	11%	11%	11%
- Age Pension	26%	Supplement 0%	Supplement 0%
Less Means Test Adjustment	(63-7) x .4 = (22%)	0%	0%
Gross Income	**67%**	**63%**	**69%**

Forecast cash flow position at various stages of life cycle relative to "modest but adequate" living standard is as follows:

	Single in workforce (%MTAWE)	Single Retired (% MTAWE) Current Rules 9% SG Contributions	Single Retired (% MTAWE) Suggested Model 9% SG Contributions	Single Retired (% MTAWE) Suggested Model 10% SG Contributions
Gross Income				
- Earnings	150%	0%	0%	0%
- Pensions	0%	67%	63%	69%
- Income Support	0%	0%	0%	0%
Total Gross Income	**150%**	**67%**	**63%**	**69%**
Less				
- Income Tax	36%	3%	1%	3%
- Voluntary Super Contributions	15%	0%	0%	0%
- Housing Costs	25%	4%	4%	4%
"Discretionary" Income	**74%**	**60%**	**58%**	**62%**
"Modest but adequate" living standard benchmarks				
- Cost of 1 adult	34%	34%	34%	34%
- Cost of working	3%	0%	0%	0%
Benchmark	**37%**	**34%**	**34%**	**34%**
Living Standards Index = Discretionary Income / Benchmark	**2.00**	**1.76**	**1.71**	**1.82**

Lower Income Single

Forecast retirement income comparison after 45 years is as follows (% MTAWE):

	Current Rules 9% SG Contributions	Suggested Model	
		9% SG Contributions	10% SG Contributions
Earnings 75% MTAWE			
- Compulsory Super (at 9%) buys	24%	24%	27%
- Voluntary Contributions buys	6%	6%	6%
- Age Pension	26%	Supplement 10%	Supplement 7%
Less Means Test Adjustment	(30-7) x .4 = (9%)	Less (6-7) = <0%	Less (6-7) = <0%
Gross Income	**47%**	**40%**	**40%**

Forecast cash flow position at various stages of life cycle relative to "modest but adequate" living standard is as follows:

	Single in workforce (%MTAWE)	Single Retired (% MTAWE)		
		Current Rules 9% SG Contributions	Suggested Model	
			9% SG Contributions	10% SG Contributions
Gross Income				
- Earnings	75%	0%	0%	0%
- Pensions	0%	47%	40%	40%
- Income Support	0%	0%	0%	0%
Total Gross Income	**75%**	**47%**	**40%**	**40%**
Less				
- Income Tax	13%	0%	(4%)	(4%)
- Voluntary Super Contributions	8%	0%	0%	0%
- Housing Costs	25%	4%	4%	4%
"Discretionary" Income	**29%**	**43%**	**40%**	**40%**
"Modest but adequate" living standard benchmarks				
- Cost of 1 adult	34%	34%	34%	34%
- Cost of working	3%	0%	0%	0%
Benchmark	**37%**	**34%**	**34%**	**34%**
Living Standards Index = Discretionary Income / Benchmark	**0.78**	**1.26**	**1.18**	**1.18**