

SURVIVE THRIVE



Natural Selection

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The Age Pension means tests: contorting Australian retirement

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AGENDA

- History & description of means tests
- Treatment of principal residence
- Integrating the Age Pension and superannuation
- Calculated “Effective Marginal Tax Rates” (EMTRs)
- Consequences
- Evaluation against criteria
- Remedies

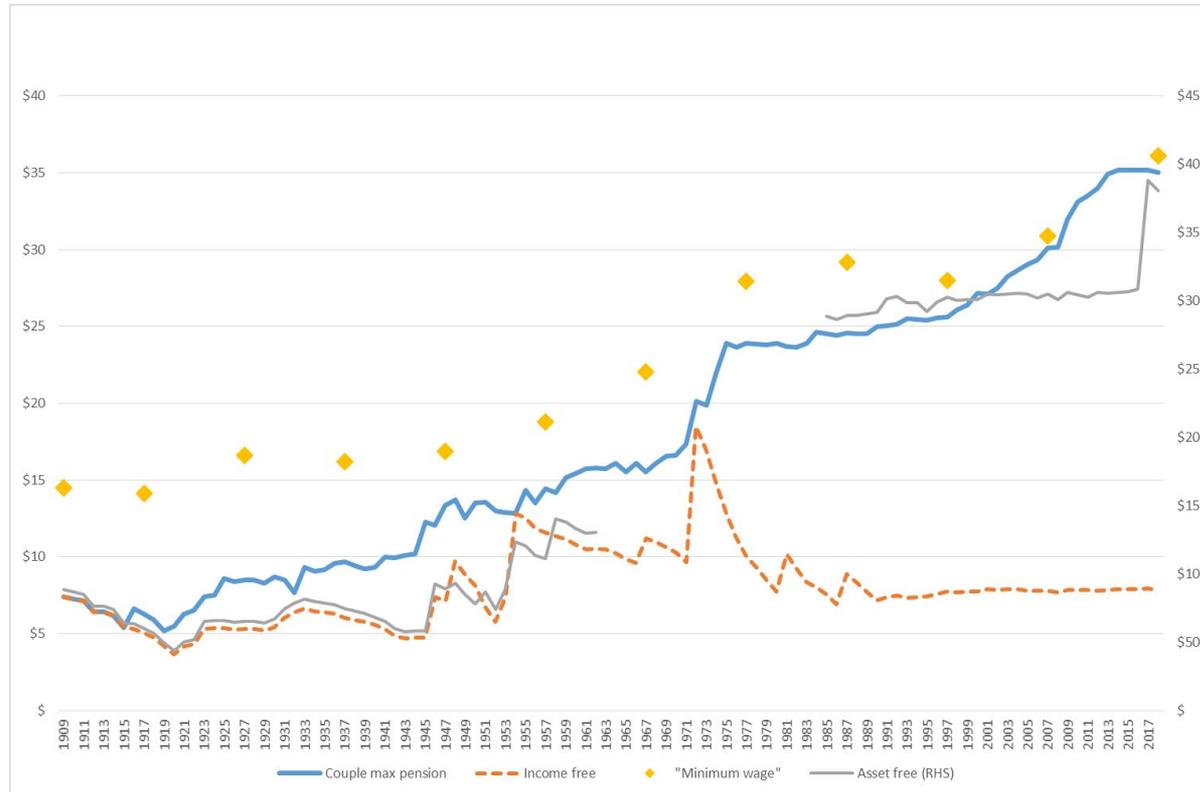
Description of current tests

- Means testing comprises an income test and an assets test
- The test that produces the lower resulting pension is the one that is applied
- Current parameters are shown in the table at right
- Note high asset test taper rate of 7.8% (was 3.9% prior to 1.1.2017)

AP projection assumptions

AP Single	23,254
AP Couple	35,058
Lower AT Threshold Single	253,750
Lower AT Threshold Couple	380,500
AT Taper Rate	7.80%
Lower deeming rate	1.75%
Higher deeming rate	3.25%
Deeming threshold - Single	50,200
Deeming threshold - Couple	83,400
Income test threshold single	4,368
Income test threshold couple	7,800
Income test taper rate	50%

Age Pension and means tests limits (2018 \$000's)

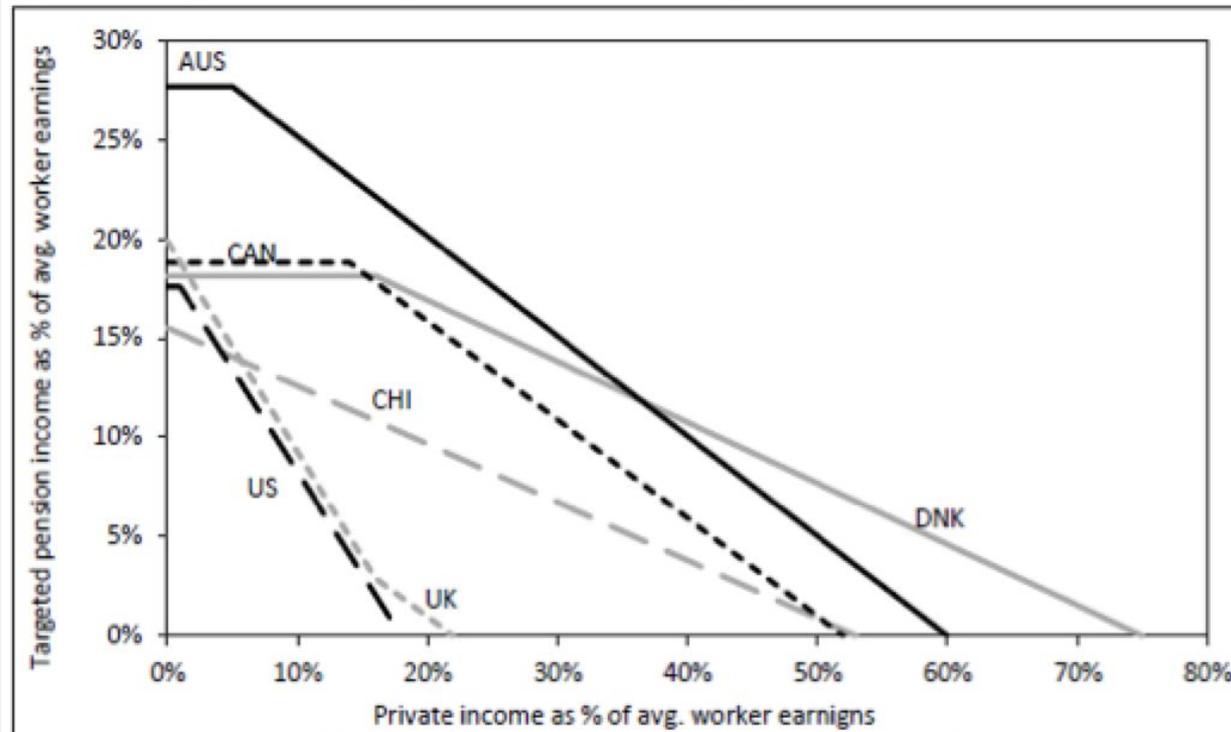


The pension became progressively more universal until the seventies

https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/Publications_Archive/online/Aged3

International comparison – income tests

Figure 3. Design of income test, Selected OECD countries, 2012-2014

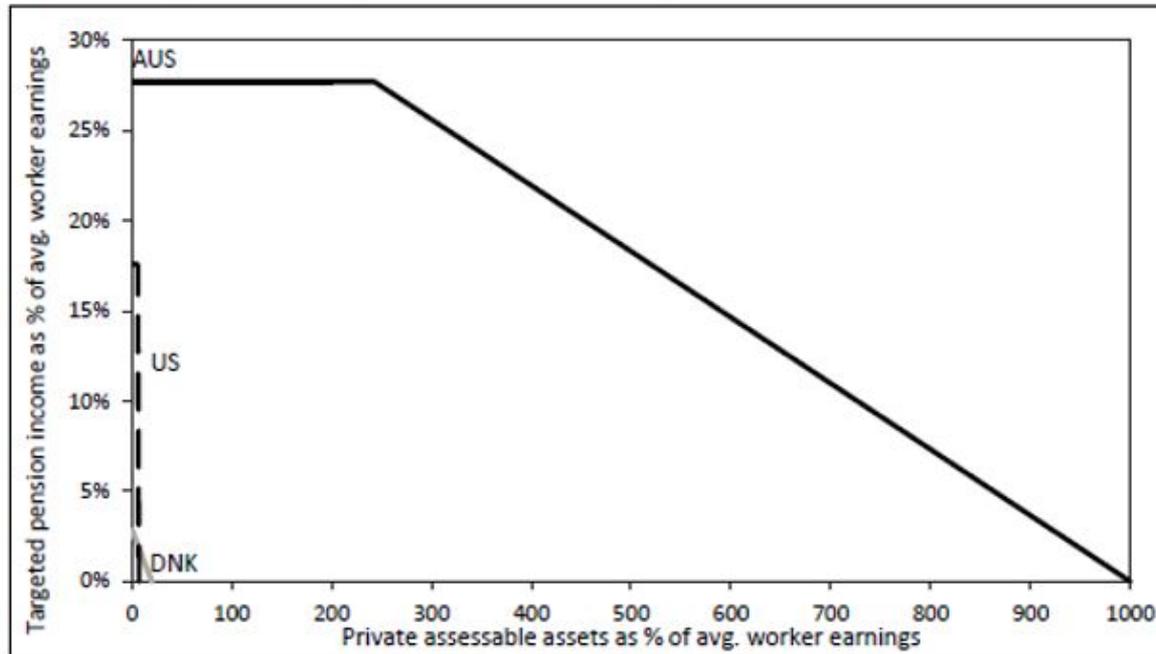


Income tests are common and sensible

From: Chomik, R., Piggott, J., Woodland, A.D., Kudrna, G. and Kumru, C.S., 2015. Means testing social security: Modelling and policy analysis.

International comparison – asset tests

Figure 4. Design of asset test, Selected OECD countries, 2012-2014



Government pensions seem seldom asset tested

Note: Based on single (home-owning) pensioner. In Australia, assessable assets exclude owner occupied housing. In Denmark, two means tested pension elements exist, one is income tested, the other is asset tested. Source: Authors' compilation based on country sources and OECD (2013).

From: Chomik, R., Piggott, J., Woodland, A.D., Kudrna, G. and Kumru, C.S., 2015. Means testing social security: Modelling and policy analysis.

Criteria for evaluation

- **Neutrality** – should not advantage particular assets or products
- **Equity** – treat people with similar means equally, less income support for those with greater capacity to support themselves
- **Resilience** – can be applied to a range of products and assets
- **Integrity** – avoid “gaming the system” to get more pension
- **Fiscal sustainability** – have regard to the cost to the taxpayer
- **Simplicity** – rules should be easy to understand

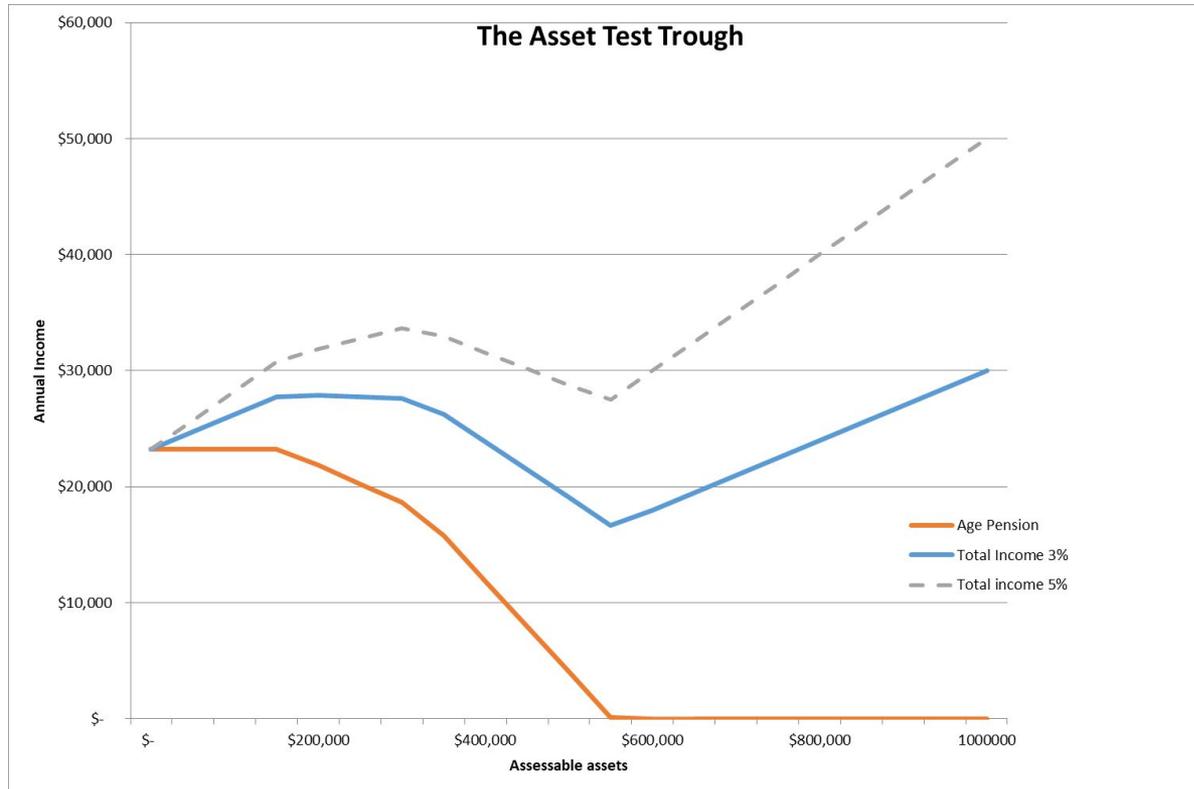
Housing

- Difference in treatment of principal residence is egregiously inequitable (and easy to fix!)
- Position of non-homeowners not in social housing is dire – 90% of rents exceed \$10Kpa, cf housing assistance of \$3,500pa
- We should double housing assistance to non-homeowners
- Conversely some live in very valuable homes & receive AP
- Eight reports and reviews recommended including the home
- Include value of home, but allow transitional arrangements
- Expand the Pension Loans Scheme to non-pensioners (Done)

Integration of welfare and superannuation

- Age pension and compulsory super are two key pillars of retirement incomes in Australia
- BUT because of high EMTRs there are strong incentives to adopt a variety of financial strategies (see later slides)
- AND it is hard to work out how to fit the pieces together to produce a sensible result (sustained real spending)
- Assets test means if you have more assets you get less total income (due to post-1/1/2017 taper rate of 7.8%, see chart)

Impact of assets test on total income

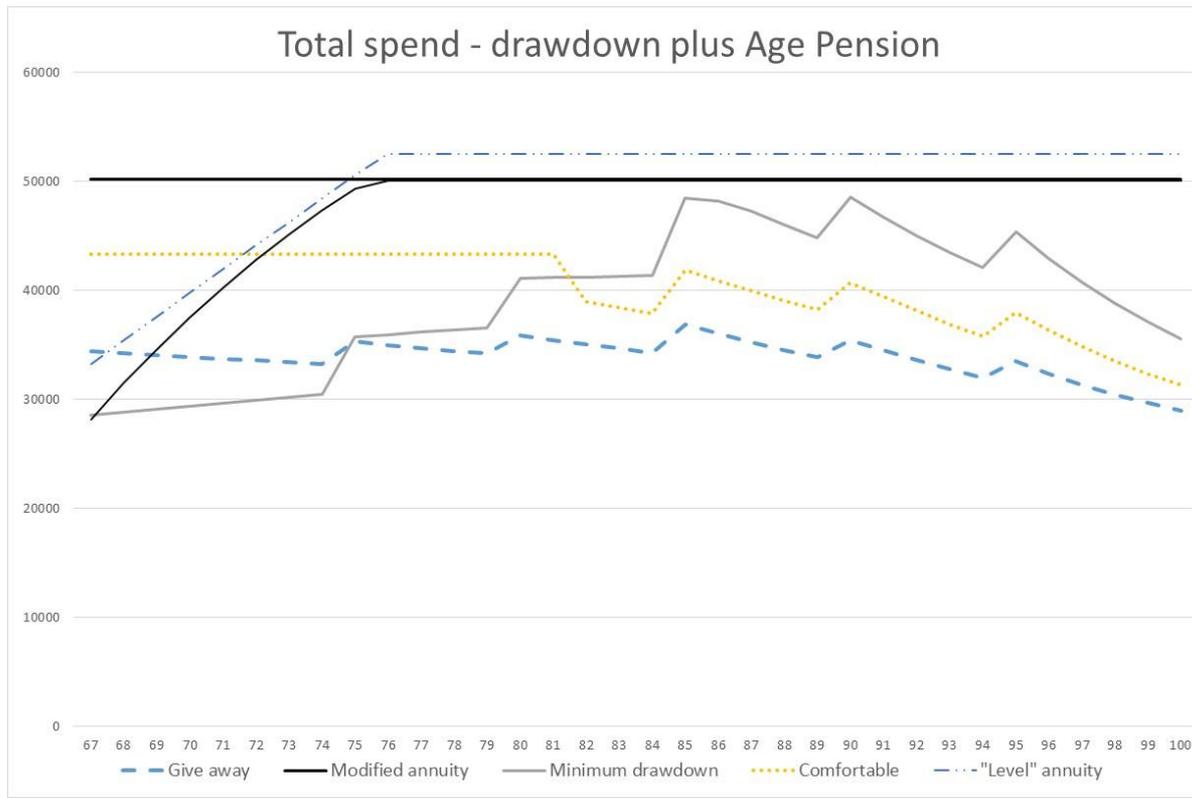


Assumes no consumption of assets

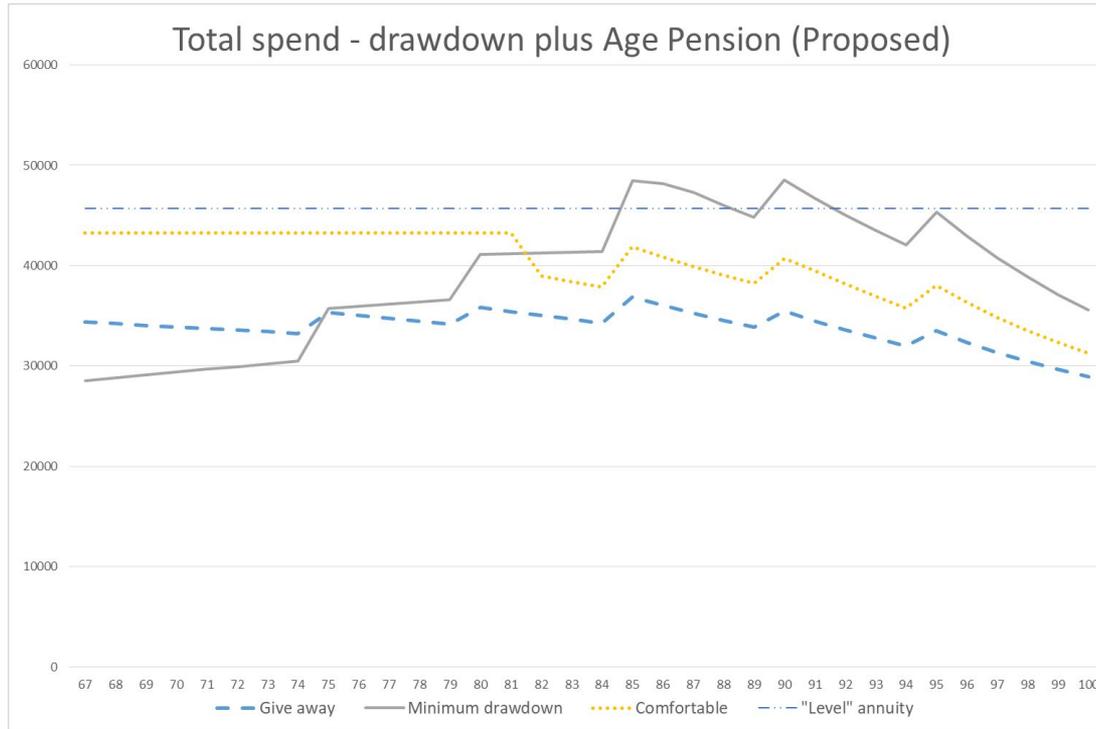
Alternative approaches to drawdown

- Minimum drawdown – spend the SIS minimum (this is what many retirees do in practice) – income from the AP is “on top”
- Give away enough money to escape the assets test, live on AP plus a modest ABP (drawn down at SIS minimum % rate)
- Maintain a target lifestyle (eg ASFA “comfortable”) for as long as possible then fall back on AP
- Use 100% of assets to purchase a level (indexed) life annuity
- Use majority of assets to purchase a level (indexed) life annuity but not 100% - use a small ABP to “levelise” total income allowing for AP

Alternative approaches to drawdown – total income



Alternative approaches to drawdown – total income (2)



Alternative approaches to drawdown - EMTRs

Strategy	EMTR for asset testing range
Spend SIS minimum	66%
Give away assets to avoid assets test	2%
Maintain “comfortable” lifestyle then fall back to AP	52%
Purchase level indexed life annuity (current rules) with bulk of assets plus small ABP to “levelise” real spending	45%

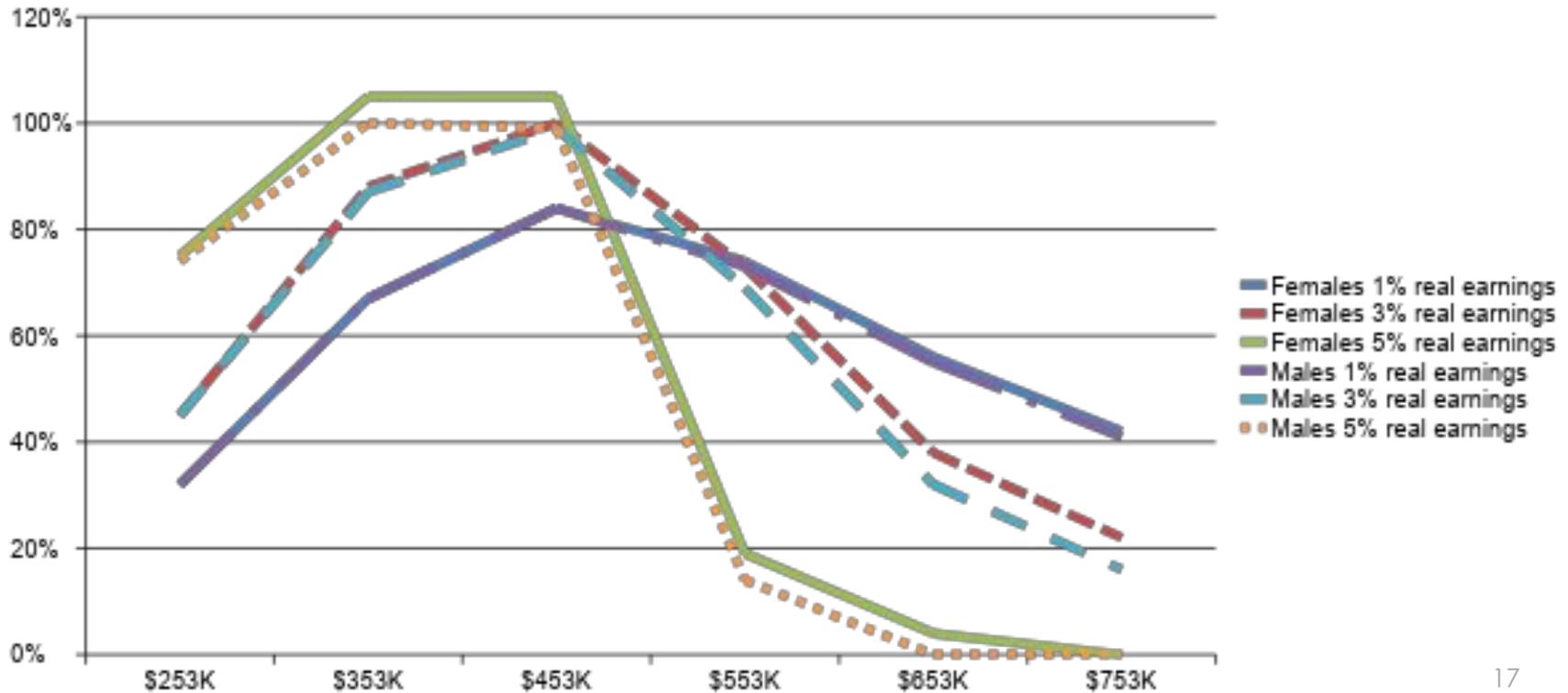
More Granular EMTR calculations (assuming SIS minimum drawdown)

	Singles (\$000s)		Couples (\$000s)	
	X	δ	X	δ
Lower third of assets test range	253	100	380	150
Middle third of assets test range	353	100	530	150
Upper third of assets test range	453	100	680	150
First layer above upper limit	553	100	830	150
Second layer above upper limit	653	100	980	150
Third layer above upper limit	753	100	1,130	150

\$X is the base level of assets held when the pensioner first becomes eligible for AP

\$δ is an incremental amount of assets in addition to \$X hypothetically held when the pensioner first becomes eligible for AP

EMTRs by gender, investment return and assets



Sample result table (single females)

TABLE OF RESULTS - UPPER THIRD OF ASSET TESTING RANGE

Extra Drawdown	Real Earnings Rate							
	0%	1%	2%	3%	4%	5%	6%	7%
0%	77%	86%	97%	108%	109%	104%	69%	34%
1%	66%	73%	80%	89%	98%	99%	95%	63%
2%	57%	62%	68%	75%	82%	89%	90%	87%
3%	50%	54%	59%	64%	70%	76%	82%	82%
4%	45%	48%	52%	56%	60%	65%	71%	75%
5%	41%	43%	46%	49%	53%	57%	61%	66%

Consequences

- High EMTRs imply strong incentives to adopt strategies targeted at maximising age pension entitlements
 - Spend down faster (holidays, travel)
 - Give money away to heirs (5 years before qualifying age)
 - Renovate house (or buy a larger or nicer one!)
- These effects distort consumption decisions and asset prices
- Also because the incentives are strong, the govt. should expect much higher liability for future age pension than if retirees disinvested conservatively

Evaluation

- **Neutrality** – annuities get favourable testing treatment but ABPs can be drawn down to avoid assets test entirely - ?
- **Equity** – treatment of homeowners and non-homeowners is unfair as is failure to recognise age as a variable - ✘
- **Resilience** – rules can be applied to all assets and income ✔
- **Integrity** – planners actively strategise to maximise AP - ✘
- **Fiscal sustainability** – the taxpayer pays for these strategies - ✘
- **Simplicity** – rules are understandable but make it difficult to produce the right “result” (level real sustainable income) - ✘

Possible remedies

- Revert to former asset test taper rate (3.9% of assets in excess of lower threshold)
- Abolish the income test and convert superannuation balance to an imputed income stream using age-specific annuity factors
- Value of principal residence could be annuitised or rent could be imputed
- Introducing changes is likely to require rational thinking, informed discussion, political courage and ideally a bipartisan approach

Questions & discussion

