Institute of Actuaries of Australia

New Ideas for Age Pension Reform - Discussion Paper

By Geoff Dunsford and Darren Wickham

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New Ideas for Age Pension Reform

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DISCUSSION NOTES

New Ideas for Age Pension Reform - Discussion Paper

Purpose of paper

The purpose of the paper is to consider a range of aspects of the Age Pension structure and benefits, and to suggest a number of "solutions" to problems.

It is intended to provoke wide discussion at forthcoming meetings – but not so wide as to lose the opportunity to achieve possible consensus on major issues and their potential solutions.

It is hoped that the results will contribute to an Institute submission to the current Henry review of Taxation and the Age Pension.

Reflections on Australia's Retirement Incomes System

One major aspect of the Age Pension system is its impact on retirement incomes generally, and the needs they are required to satisfy.

We are told that our "3 Pillars" system of compulsory private, voluntary private and state provision of retirement incomes is the envy of many countries.

In practice, the "3 Pillars" have each developed independently. Rather than being the basis for a consistent and integrated retirement incomes policy, they make for an incoherent and dysfunctional whole.

Moreover, we don't actually have a retirement *incomes* system!

Our private superannuation system produces tax free lump sums at retirement (after age 60) from government legislated contributions as well as voluntary contributions. These are given to people who largely have no experience of handling such amounts. There is no compulsion or encouragement to convert any part of the benefit to a lifetime pension.

For many, lump sum superannuation can generate a "Winning the lottery and how do we spend it" mentality – encouraged by promoters of retirement lifestyle products. When the excitement dies down, retirees are told they should manage the lump sums to support their desired living standards through perhaps 30 years or more of uncertain needs. And their financial advisers compound the uncertainty by recommending unstable investments which require regular review of mix and income drawdown, and reducing the benefits by levying fees for their obscure advice.

Arguably, it is irresponsible of a government to support a private superannuation industry which effectively requires retirees to have their benefits subject to all the risks of investment fluctuation, inflation and longevity, providing only a safety net in the form of the Age Pension.

We also have a means testing system (to limit the cost of the Age Pension and to target benefits to those that need them most) which is highly complex, discourages workforce participation, requires regular time consuming "customer" interviews, penalises inadvertent mistakes, and produces anomalous outcomes.

Perhaps the most outrageous anomaly is the opportunity for retirees to spend their tax free superannuation benefits (built up from tax advantaged contributions invested in tax advantaged funds), and then claim Age Pension benefits!

Even the superannuation tax advantages are highly distorted - in favour of those on higher incomes. Contributions tax ***concessions*** amount to a net 31.5% for top earners, down to a *negative* 15% for those on lowest incomes! The recent Better Super tax changes mean that the only taxes on benefits remaining are those on the poor (via the Age Pension means test). At each stage (contribution and benefits) the system is highly regressive.

Major Review Overdue

Arguably, a major review of the Age Pension and related benefits is required because there hasn't been one for many years.

Perhaps the most important issue is the effects of the ageing of the population leading to a projected increase in the cost of the Age Pension from **2.9%** GDP to **4.4%** GDP in 2047 (Intergenerational Report 2002 and update in 2007).

There are frequent comments in the media regarding the financial difficulties of many retirees. The means testing system is irritating for Age Pensioners, and provides confusing outcomes. These are more than adequate reasons for a new Government to institute a review.

Dr Ken Henry has been asked to provide a report on the Taxation system which will include the Age Pension. His comments on the Age Pension system are targeted for February 2009.

Ideally, we would like to suggest moving to a model which focuses on *lifetime incomes* and better integrates private superannuation and state funded benefits. Some thoughts on Integration are attached as Appendix A – page 7.

However, we believe that greater notice will be taken of our proposals if we adopt a less radical approach. The suggestions made focus on overall future government cost reduction, while eliminating current problems and anomalies.

Many of the latter relate to the existence of means testing. Appendices J and K provide alternative approaches towards the elimination of means testing. Arguably, these represent moves towards better integration of state and privately funded retirement benefits.

Structure of Paper

Various issues and questions and possible answers and solutions are raised in an abbreviated form below, to provide a basis for discussion. These are explored in notes which are attached as Appendices, as background for the discussion meetings.
Any welfare system must deal with the twin objectives of providing:

- safety net support; and

- incentives to avoid the need for welfare support,

while utilising taxpayer dollars wisely and fairly.

Funding for each of these objectives within an overall budget results in an inevitable and perennial conflict.

The various “solutions” to problems in this paper are options which address this conflict in different ways. As a discussion paper it is not intended that such suggested solutions will always be consistent with each other. Ultimately, decisions in this regard are political.

Discussion Topics

(i) What is Purpose of Age Pension?
(Notes attached as Appendix B – pages 10-12)

- Current?
- Proposed?

(ii) Current Scorecard (Notes attached as Appendix C – pages 13-18)

Is the Age Pension achieving its purpose?

- Alleviation of Poverty?
- Fair Support for Retirement Lifestyle?

(iii) Current Issues/What needs reform?/Why?

- Projected Increasing Cost
  (Notes attached as Appendix D – pages 19-22)
- Compulsory Superannuation Scheme – Inadequate Benefits?
  (Notes attached as Appendix E – page 23-25)
- Means Test Problems
  (Notes attached as Appendix F – pages 26-29)

Options for Reform

(i) Options to Increase Workforce Participation
(Notes attached as Appendix G – pages 30-37)

- Improve Pension Bonus System

- Ignore Personal Exertion earnings in Means Test after Age Pension Age

- Increase the Age Pension Age – ie the minimum age from which the Age Pension becomes available
  (Note: need to align Disability, Unemployment and Age Pension benefits)

- Replace the Age Pension with a single "Unable to Work" Pension (towards abolishing retirement - *See Appendix L page 58)*

- Other?

(ii) Other Options to Reduce Costs
(Notes attached as Appendix H – pages 38-42)

- Increase compulsory superannuation contributions

- Introduce measures to reduce "double dipping" (ie spending superannuation and claiming the Age Pension);

- Tighten the Means Tests for the Age Pension

- Use Personal Assets <u>before</u> claiming <u>any</u> Age Pension

- Other?

(iii) Options to Simplify System
(Notes attached on Means Test Problems and Principles for Solutions as Appendix E – pages 23-25)
(Notes attached on Age Pension and Fringe Benefits as Appendix I – pages 46-47)

- Move to Single Means Test

- Index Means Test Thresholds in line with Pension Increases

- Exempt Age Pension from Personal Taxation

- Incorporate Supplementary Cash Support payments into Age Pension

- Other?

(iv) Towards Elimination of Means Testing

- Abolish Means Test Completely – Universal Age Pension
  (Notes attached as Appendix J – page 45-50)

- Purchase the (Balance of the) Full Age Pension
  (Notes attached as Appendix K – pages 51-57)

- Other?

APPENDIX A

Integration of State and Privately Funded

Retirement Income Benefits

What does Integration look like?

An integrated pension system might have the following qualities:

- Consistent eligibility ages (to receive benefits)
- Has no disincentive to save additional amounts in private system
- Has no incentive to dissipate private savings quickly
- Does not discourage workforce participation
- Similar patterns (timing and growth) of payments

Perhaps the ideal position from the point of view of a pensioner is *the receipt of a single regular payment,* at least monthly, which combines both state and privately funded *pensions*, indexed to inflation, payable for life. Ideally the payment is not taxed; however, if it is taxed, it is taxed consistently across both pensions.

(Ultimately, this could apply to other "unable to work" pensions, ie disablement and unemployment – and, if/when retirement is abolished as represented by Appendix L)

The integrated pension payment does not need to represent the total of all the pensioner's retirement resources – but it should be sufficient to provide *a modest lifestyle* should other resources become exhausted.

Separate payments from the state and private resources which provide a total equal to that suggested for the single payment above would be an acceptable (and rather more likely) alternative scenario. For some people, receipt of parts of their total income through the month facilitates budgeting.

What are the Possible Approaches for Integrating State and Private Pensions?

Perhaps either:

(a) A universal state Age Pension which provides a modest lifestyle – say equivalent to the Westpac/ASFA model. Their latest survey suggests an annual expenditure of $19,141 for single retirees owning their homes. This number is around *20%* higher than the current Age Pension, including the value of concessions and allowances. (For couples, the equivalent income is $26,851 which is about 5% more than the Age Pension and "fringe" benefits.)

OR

(b) A combination of a universal state Age Pension, and a *compulsory* private pension *payable on the same terms as the state pension* – again totalling sufficient for a modest lifestyle.

If the private market was unable to provide such a pension, or the purchase price was considered to high, the government could provide reinsurance or issue bonds to allow ceding of the risks of inflation and longevity to assist life insurers in offering acceptable terms. (The private pension could include the option of purchasing a "capital protection" benefit in the event of early death.)

OR

(c) A combination of a means tested state Age Pension, and a compulsory private pension, where any difference in the level of the private pension compared with that expected from applying the same rate of indexation as the Age Pension, is wholly complemented by a change to the Age Pension.

Such a change could arise as a result of different indexation applying, or investment market movement. This could occur in the case with profits or investment linked lifetime annuities; however these are not currently available.

Effectively, the government would be accepting inflation and investment market risks. (This already happens to some extent through the operation of the means test "taper".) However, this may be considered a cheaper option than providing a universal pension – as well as satisfying political demands for continued means testing.

The lack of availability of widespread use of private lifetime pensions/annuities means that Integration of the above basis cannot currently be introduced

What is reasonable for Government Action?

Simple introduction of the compulsory purchase of lifetime annuities at retirement is currently politically impossible. The flexibility of simply drawing down on lump sum superannuation benefits as money is needed, is considered the far more attractive option by retirees.

It is possible to envisage introducing a requirement for *future compulsory* superannuation contributions to be placed into accumulation accounts which required part of the lump sum at retirement to *compulsorily purchase an indexed pension*. However, this would take a generation to build up sufficiently large accounts to represent reasonable integration with the Age Pension.

Eliminate Means Testing?

Perhaps the focus needs to be on reducing the complexity of the current form of "integration", eg, simply eliminating means testing, or at least limiting it to a single test on retirement or at a specific age.

Where the retiree's assets or income are below the upper threshold for a part Age Pension under current rules, consideration could be given to either:

(a) Requiring the retiree to use their personal resources until they fall to the lower threshold, before *any* Age Pension is paid – and then paying it at the full rate. This proposal is considered in the section on "Tighten the Means Tests" in Appendix H.

OR

(b) As a *condition* for receiving the part Age Pension, retirees must use some of their personal resources to purchase an indexed lifetime annuity - either from a life office or from the government – for the *balance* of the Age Pension. Thus the retiree would have lifetime pensions totalling the amount of the full Age Pension. This proposal is expanded on in Appendix K.

OR finally,

(c) It may be possible to *reintroduce* the concept of a *Universal Age Pension* – ie making the current Age Pension available to all without any means test. The proposal in Appendix J sets out a new approach to funding this, which could meet the objections of those who believe that "welfare" should not be provided to "those who don't need it".

The approach includes changes to taxes other than any on the Age Pension itself, which would be paid mainly by "the rich".

APPENDIX B

Purpose of Age Pension

Two Main Purposes

In looking to the future, it may be worthwhile to reflect on the purpose of the Age Pension. What has the purpose been historically? What is the purpose today? Is the purpose likely to change in the future?

Arguably, the purpose can be considered as either:

(a) representing the government's main method of alleviating poverty for those unable to work at older ages, or

(b) providing a necessary part of the population's income in retirement, or

(c) a combination of both.

History – Tension between the Purposes

Historically, when only the privileged few had the opportunity to make suitable provision for retirement, the Age Pension was established in 1901 in NSW (and taken over by the Commonwealth in1908) as a means of alleviating poverty for the majority of older people.

Although debate has continued for a century as to the nature & purpose of the age pension, this debate has mainly centred on the provision of a universal pension versus the application of a means test. With means testing embodying the philosophy of the pension being for targeted poverty alleviation, the universal approach is favoured by those who view the pension a recompense for a contribution to a lifetime's contribution to society.[1]

The tension between different purposes was evident in the preamble to the NSW Old Age Pension Act (1900).

"It is equitable that deserving persons who during the prime of their life have helped to bear the public burdens of the Colony by the payment of taxes and by opening up its resources by their labour and skill, should receive from the Colony pensions in their old age"

While this suggests a universal view of the pension, the first NSW pension was means tested. Furthermore it was set at a rate that was considered affordable rather than one sufficient to keep an individual from destitution.

The fact that payment of the Age Pension did not depend on contributions (which applied in the UK from shortly after the end of the second World War) represented further evidence of the "safety net" nature of the Australian Age Pension.

There have been a number of Government enquiries into a social insurance / contributory universal age pension scheme. In fact, Australia has twice had legislation pass through parliament for a contributory social insurance scheme which included it. In 1929, the

[1] Unikoski, I "Veterans of Labour, Veterans of War" DSS (1989)

legislation was never proclaimed (following a change of government). In 1938, the scheme commencement was twice postponed and then finally lapsed in 1939.

In the 1970's, the Whitlam government started a process for the elimination of the means tests. However, this was abandoned by the next government.

Since then, there have been occasional calls for the Age Pension to be made a universal pension, with the personal taxation system providing a form of means testing adjustment (notably from the IAAust in the 1990's). Such calls have been largely made to eliminate what has become a complex and inconsistent means testing system which requires continuous monitoring of each pensioner's financial circumstances. However, making the government pension "universal" would increase the cost of Age Pensions from **$24b to $35b**.

In practice, introduction of a universal pension has not been seriously considered by any government since the 1970's.

The introduction of compulsory superannuation contributions to private funds in 1986 was partly in response to expectations that the Age Pension, even in the current means tested form, would become too costly a burden for the government as the population aged.

Government View

Today, with the strong focus on widespread private superannuation, the Age Pension tends to be seen primarily as a safety net for the poor. Centrelink Information Chapter 12, states: "Age Pension is a safety net for older people who are not able to fully provide for themselves. It is paid so people of Age Pension age have adequate income". Younger people today tend not to anticipate it. Financial plans tend to focus on it only when the client is closer to retirement.

It is true that the 2007 Intergenerational Report commented that, (in 40 years time) "the proportion of the eligible age group not receiving any Age Pension is projected to rise only slightly". However, this is largely because private fund contributions at the current rate of 9% of earnings (less cost of insurance benefits) are expected to be too small to provide adequate retirement benefits on their own. It is possible in the future that the rate will be increased to the (often suggested for adequacy) 15% level – possibly with some form of "soft compulsion". This would then have a real impact on reducing Age Pension costs.

[In the 2005 Report "Future Ageing" the Parliamentary Standing Committee on Health and Ageing suggested (para 7.22) that "the age pension represents the ***safety net*** of the three pillars retirement income scheme"]

Financial Planning

The relatively generous means tests and the availability of various fringe benefits in conjunction with the receipt of even a small part Age Pension, result in their inclusion in financial planning for many people approaching retirement. Accordingly, the Age Pension is seen by such people as part of their retirement benefits.

Purpose in the Future - Shifting Balance between the Two Purposes

The main focus of the Age Pension can be expected to remain "the alleviation of poverty" in the foreseeable future. This would continue to make the purpose consistent with the payment of other benefits, like unemployment and disablement.

However, in the longer term, with society becoming wealthier and healthier, and with more than half the retired population subject to continuous, invasive and administratively complex means testing, moves towards making the Age Pension a better integrated part of the population's income in retirement may well be initiated again.

In fact, with improving health and wellbeing for the over 65s – it can be argued that, in providing a benefit to an ever increasing proportion people who are healthy and capable of work, the Age Pension is moving away from a philosophy of targeting needs.

A paper by the Australian Parliamentary Library[2] made the observation that the goal of retirement policy appears to be shifting towards keeping people in the workforce. The Age Pension already has had a minor role to play in that overall goal (eg Pension Bonus Scheme), but may develop into an expanded role if incentives to remain in the workforce are introduced.

It is worth noting that the introduction of the Pension Bonus Scheme had little to do with the Age Pension's primary purpose of alleviating poverty in old age.

With a policy focus on workforce participation, the use of the expression "Retirement Incomes Policy" may well need to change to "Old Age Incomes Policy" to reflect the changing nature of 'retirement'. Indeed the World Bank (and their "pillars" system) now use this terminology.

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[2] Nielson, L "Superannuation, social security and retirement income" , Australian Parliamentary Library (2005)

APPENDIX C

Age Pension – Achieving its Purpose?

Primary Purpose – Poverty Alleviation

The primary purpose in Centrelink's words is: "so people of Age Pension age have adequate income". This does, of course, beg the question: *"to meet what needs?"*

As a minimum, "adequate income" can reasonably be expected to mean sufficient for the alleviation of poverty, ie, to meet basic needs in relation to sustenance, clothing, shelter, health, communication and transport.

Henderson "Poverty Line"

One measure of poverty is an income less than the Henderson "Poverty Line". This was established in 1975 following the Henderson Poverty Inquiry.

The initial yardstick was based on a 1964 study by Henderson which determined poverty as an income below an amount equal to the "basic wage" plus child endowment, less personal income tax. The "basic wage" was an amount determined from time to time by the Arbitration Commission as the minimum wage to be payable to a (male) employee. Historically this was based on a 1907 decision to determine this as the amount required "to support a family (ie couple and two children) in frugal conditions".

Since the "basic wage" was abolished in 1967, the 1975 Inquiry updated the 1964 poverty level in line with average wages, to arrive at the "Poverty Line" for such a family. Other "poverty lines" were established for other family groups by developing suitable ratios to be applied to the main "Poverty Line". Since that time the poverty line levels of income have been increased in line with Household Disposable Income (HDI).

Arguably, of course, each update should focus on the cost of the basket of goods and services making up a definition of basic needs in "frugal conditions", with a review from time to time as to the content of that basket.

In practice, this has not happened to date. However, the Melbourne Institute, which prepares the quarterly update, advises the difference in the effect of applying the CPI changes and HDI changes. The current "excess" poverty line income levels on the HDI basis are 46.2% higher than they would have been if they had been updated using CPI. It seems likely that the cost of a basket to meet today's basic needs would require a lower income than the "Poverty Line".

Different poverty lines apply to "singles" and "couples", and to people in different family circumstances. Our focus is on the "Not in the labour force" group. A comparison of the Age Pension with the Henderson Poverty Line for this group, based on the September 2007 update, is as follows:

Weekly Income ($)	Age Pension ($)	Rent Assistance ($)	Total Income ($)	Henderson Poverty Line ($)
Single Person	284.68	52.00	**336.68**	**303.48**
Couple	460.63	49.10	**509.73**	**429.88**

The Age Pension numbers include pharmaceutical allowance, utilities allowance and seniors' bonus which are paid to all Age Pensioners. Rent Assistance shown is the maximum payable. ie for single renters paying at least $116 per week and couples paying $141 per week. (All numbers relate to pre September 2007 position).

Poverty Line excluding Housing

In addition to the Poverty Line (which includes the cost of housing), the Melbourne Institute publish corresponding numbers excluding the cost of housing. It is assumed that the difference is equivalent to the cost of renting (although the proportion of the total costs is based on a 1954 New York survey! [Australian Economic Review 4th quarter 1987]).

Home owners, of course, still have some housing costs. Assuming consistent equivalent numbers for these are say, 35% of the implied rental costs, a possible comparison for home owners is:

Weekly Income ($)	**Age Pension ($)**	**Henderson Poverty Line excluding Housing Costs ($)**	**Estimate Housing Costs ($)**	***Total Equivalent "Henderson Poverty Line" for Home Owners ($)***
Single	**284.68**	181.09	42.84	**223.93**
Couple	**460.63**	295.33	47.09	**342.42**

Other Measures of Poverty

A number of welfare organisations have, for some years, focussed on "relative poverty". In line with some other OECD countries, this is taken to mean an income less than 50% of median or average earnings. This approach suggests that the living standards of the poor should be measured against the living standards of the total population.

A major problem though, with a "relative income" based definition, is that it becomes difficult for a government, even in a rich society, to determine policies to eliminate poverty. As living standards grow with the whole population benefiting, the number of "relatively poor" are likely to remain largely unaltered. Of course, the government could introduce a major income redistribution policy; however, this may well have negative economic consequences generally.

The expression "relative poverty" undermines the picture of genuine poverty to which the population may be strongly sympathetic, but less so when it is qualified in such a vague way. "Disadvantaged" may be a better description of people who are not in poverty, but for whom various specific educational/welfare policies may be desirable and generally supported.

Comments on Henderson Poverty Line Comparison

For people not in the labour force without dependants, the Henderson Poverty Line numbers are higher than the "relative poverty" results on the "50% of median or average earnings" basis for this group.

Consequently, the above comparisons suggest that the Age Pension, in conjunction with Rent Assistance, provides an income above poverty levels on any of the recognised measures. This comment is enhanced when one takes into account the additional federal and state based "fringe benefits" to which pensioners are entitled, eg, rebates for telephone, council and water rates, and reduced public transport fares. In addition, for those without other means, medical and health services are essentially free.

However, there are many subtleties in the eligibility rules for the Age Pension, the operation of the means tests and qualification for rent assistance, which can leave some people, hopefully only a minority, below the Henderson Poverty Line.

Some people renting and preferring (for social reasons) to remain living in an area of higher priced accommodation in a major city, may consider themselves disadvantaged relative to home owners as a result of limitations on rent assistance. There are no limitations on the value of the home which is exempt from the means test.

On the other hand, home owners with mortgages do not have any interest or repayment costs recognised under the Age Pension system – nor in the poverty line income numbers.

It is worth noting that there are not infrequent calls from welfare groups to alleviate the problems of people living in poverty. Such calls may well be justified in the case of those under age 65 since current welfare benefits in their cases may be inadequate. For example, the unemployment benefit is significantly less than the Age Pension.

The analysis in this Appendix suggests that a universal increase in the Age Pension is not justified in relation to *poverty* standards.

Westpac/ASFA Retirement Living Standards

Westpac and ASFA publish "modest" and "comfortable" living standard budgets for retirees living in their own homes. These were developed by the Social Policy Research Centre of the University of NSW in 2004, and are updated every 3 months.

The March 2008 results for a "modest" living standard, compared with the current Age Pension are as follows. Age Pension numbers include current pharmaceutical, and utilities allowances and the seniors' bonus, but not rent assistance, to provide a suitable comparison.

	Westpac / ASFA "modest" living standard	**Age Pension**
Single	$367 per week	$296 per week
Couple	$515 per week	$479 per week

"Frugal" Living Standard

While there will be a wide variation in retirees' actual living circumstances, it would be desirable to have a model "frugal" living standard against which to judge the adequacy of the Age Pension.

The "modest" living standard above includes transport costs on the basis of having a car. A "frugal" living standard model could assume use of public transport where seniors' concessions are available – combined with an expectation of living close to shops and transport, say in a home unit.

The "modest" living standard for a single retiree includes $45 per week spent on "leisure" items. It could be argued that a "frugal" living standard would not include all of this expenditure.

Such adjustments to the above numbers would be sufficient to enable the Age Pension to be justified as providing a "frugal" lifestyle – clearly covering the purpose of alleviation of poverty.

At the same time, it is a political decision to determine the actual level of "basic needs" which should be met by the Age Pension, eg, whether this should be expected to cover the costs of running a car.

Most retirees will have some resources in addition to the Age Pension. The first issue though, is to establish a suitable standard for a retiree *without any other resources* which should be supported by the taxpayers, in the light of current community attitudes towards meeting the needs of the disadvantaged.

Singles/Couples

The following ratios are worth noting:

	Age Pension / Henderson Poverty Line	**Age Pension / Westpac-ASFA "Modest" Living Standard**
Single Pensioner	1.27	0.81
Couple	1.35	0.93

These figures confirm Pensioner Groups' views reported in the press, that single pensioners have greater difficulty in meeting current cost pressures than couples.

Rent Assistance

It is noted that Pensioners' Associations have often drawn attention to the plight of those renting. The current rules for rent assistance are highly complex. In general, no assistance is given for rents paid up to the thresholds of $95 per fortnight for singles, or $ for couples – yes, *lower* for couples! And only 75% of the excess over these levels is paid up to the maximum thresholds of $238 per fortnight for singles and $290 for couples. Such maximums bear little relationship to rents in the private rental markets in the major cities.

Thus **maximum** Rent Assistance payments are **$107 per fortnight for singles and $95 for couples** (in total). A review of the rules, and the levels of assistance in the current housing climate, would be useful. At least, one might reasonably expect Sydney/Melbourne loadings. Further comments are included in Appendix I.

Levels of rent assistance are not currently subject to the amount of Age Pension payable. Whatever level is determined for someone without resources on a full pension, it might reasonably be expected that some reduction should apply in the case of a retiree on a part Age Pension with other resources available.

While any review would inevitably need to include other Social Security beneficiaries who are renting, this may well be desirable on the grounds of fairness.

Arguably, the determining of the housing cost element of the Henderson Poverty Line also needs reassessing.

Secondary Purpose - Part of Retirement Income

As suggested in Appendix B, the secondary purpose of the Age Pension can be considered to be as providing a necessary part of the population's income in retirement. To assess whether or not the Age Pension is successfully meeting this objective must consider the following;

1. Adequacy **-** the degree to which overall retirement incomes are adequate (ie, superannuation and the Age Pension). Does the Age Pension provide sufficient support for people to be able to attain a standard of living in retirement consistent with that enjoyed prior to retirement, on a fair basis

2. Integration **-** the degree to which the benefits are integrated with the superannuation system (as outlined in Appendix A, consistent eligibility, without disincentives etc)

Adequacy

Testing the "success" of the Age Pension in meeting this purpose arguably requires examination of pre and post retirement incomes for a range of people in different circumstances. Perhaps this should also extend to forecast positions as well as current actual situations.

This would require a range of future assumptions – in particular, levels of voluntary superannuation contributions in addition the compulsory ones. In total, the number of examples would be vast.

For the purpose of this discussion, it is proposed to focus on the broad impact of the Age Pension on retirees.

Some general comments are:

Group	***Age Pension Impact on Adequacy***
Low income earners tend to require a higher percentage of their pre-retirement earnings to maintain their lifestyle.	*positive impact*
Low income earners tend to have more difficulty in saving for retirement.	*positive impact*
Middle income earners need some support in addition to private superannuation to maintain the pre-retirement lifestyle, but not as much as lower income earners.	*Generally positive, Means Test tapers generous,*
Higher income earners are more able to save for retirement and do not need additional support.	*nil, as would seem appropriate*
Availability of "fringe benefits" in conjunction with Age Pension encourages arrangement of affairs to obtain a minimal level of pension.	*distorts financial planning*

Examples comparing retirement income outcomes for people of different working income levels are included in Appendix E – Compulsory Superannuation Scheme.

Integration

The Age Pension is poorly integrated with the superannuation system. It is complex, invasive, administratively inefficient, distorts behaviour and provides active disincentives to work, save, invest sensibly and make superannuation last.

In practice, the "3 Pillars" have each developed independently. Rather than being the basis for a consistent and integrated retirement incomes policy, they make for an incoherent and dysfunctional whole. For example, means testing the Age Pension encourages "double dipping" to run down the savings in superannuation (the first pillar is acting against the second and third pillars).

While some problems lie with the superannuation system (eg various threshold ages applying to contributions and benefits), most of the problems arise due to the existence of means testing and anomalies in its operation (highlighted in Appendix F).

Overall Comment

Given the substantial problems with integration, it is difficult to argue that that Age Pension is satisfactorily meeting its secondary objective of providing a part of the population's income in retirement.

APPENDIX D

Age Pension - Projected Cost/Funding

Introduction

The recently published second Intergenerational Report (IGR) projects the cost of Social Security and Department of Veteran Affairs Age Pensions - referred to in the article collectively as "Age Pensions" - to increase from **2.5**% GDP to **4.4**% over the next 40 years. This projection is on the basis of no change to legislation and practice (in particular, CPI indexation of means test thresholds), reasonable investment returns for superannuation funds and, in particular, no change to current trends in respect of age related work participation rates.

On the assumption of no change to taxation legislation, the Federal Budget is projected to run into deficit from 2020, and for the deficit to increase to 3.5% of GDP by 2047.

IGR understates cost of Age Pensions

As mentioned above, one of the assumptions made in the Intergeneration Report about the future cost of the Age Pension is that the income and assets thresholds are indexed to price inflation (CPI).

While the approach adopted is understandable (as it reflects the current legislation) it is highly unrealistic.

The problem with indexation of the thresholds with CPI is that they are likely to become tighter as income and assets grow faster than price inflation.

The political reality is that every so often governments will need to "tweak" the assets and income test thresholds so that they catch up with community standards of living. This was done recently with the Better Super changes.

The upshot is that the IGR projection overstates the impact of money saved from means testing.

Income tests

The Intergeneration report also assumes that rate of growth in wages and salaries will exceed price inflation by 1.75%pa (reflecting the increase in community standards of living). Pensioners earning wages and salary are therefore projected to have income growing faster than the means tests. The upshot is that more and more pensioners are assumed to be impacted by the means testing.

Consider the following table

Year	Income Test Threshold (in today's dollars)	Amount of Age Pension with no income	Amount of Age Pension if income $5,000 pa
2007	3,328	13,653	12,984
2047	1,691	13,653	12,329
Difference			$655pa

* where today's dollars are determined by deflating future values using wage inflation

If these tighter income test thresholds were applied to all current reduced rate age pensioners and a portion of full rate age pensioners – it at least another $1bn to the 2006-07 Age Pension cost.

Asset tests

However, the real impact on the future projected Age Pension costs of these tighter means tests is not the income test, but the assets test. This is because:

- The IGR says that the impact of higher superannuation wealth is reflected in the decline of full rate pensioners and the rise of part rate pensions.
- Growth in assessable assets will be faster than growth in assessable income:
  - Income from employment will only grow at wage inflation (no changes to workforce participation assumed)
  - Assessable Income from super is reduced due to deductible amount (super asset growth treated more harshly than super income)
  - Assets from super will grow due to maturity of SG system, wage inflation (of contributions) and investment returns.

A more realistic assumption is to assume that assets test thresholds also grow with wage inflation.

Year	Assets Test Threshold (in today's dollars) $	Amount of Age Pension with no assets $	Amount of Age Pension if assets $165,000 $
2007	161,500	13,653	13,516
2047	90,322	13,653	10,418
Difference			3,099

* where today's dollars are determined by deflating future values using wage inflation

IGR impact

The impact of these “tightening” means tests is shown in the table below.

Group	2007	2047	Change
Part Pension	26%	40%	14%
Full Pension	40%	35%	(14%)
DVA Pension	9%		
No Pension	25%	25%	Nil
Total over Age Pension Age population	100%	100%	

Adjustment for the impact of the “tighter” means tests due to the unrealistic indexation assumption, might mean the cost of the Age Pension projection in the future of around 4.4% of GDP, being increased to at least **4.8%** of GDP.

If the average pension paid in 2007 was around $12,400, it is not unrealistic to speculate that Treasury’s models are producing an average pension in 2047 of around $11,300 (in today’s dollars). This is based on the following:

- Of the 14% of the population growth in part pensioners – most would have pensions reduced primarily due to the assets test (although not all by the $3,099 difference above).

- The “base group” of part pensioners – ie the 26% of the over Age Pension Age population that are currently part pensioners and will be the same proportion in respect of the future population – all of this group will have had a reduction in their pension due to the application of the indexation, some by the full income test impact of $655 pa, most though by a portion of the assets test impact of $3,099.

Longevity and Fertility

The main reasons for the significant increase in the projected cost of Age Pensions were the increased number of retirees arising from the increase in fertility rates immediately after the Second World War, (“baby boomers”), combined with their increased longevity. These were also the major reasons for the projected doubling of the Federal government’s contribution to the health system over that period.

Over the last 40 years though, there has been a dramatic *reduction* in fertility rates. This is projected to lead to a major increase in the proportion of retirees relative to workers (who provide most of the taxation revenue).

This “ageing of the population” is clearly a major reason for the projected increasing Federal Budget deficits.

Possible Future Action

The increasing cost of Age Pensions could be met simply by increasing taxation or mitigated by the introduction of a compulsory contribution – as in the UK and other countries.

Alternative actions include:

- Increasing compulsory superannuation contributions – refer Appendix E for comments;

- Measures to encourage increased participation in the workforce – particularly for the over 55's – refer Appendix G for comments;

- Increasing the Age Pension Age – ie the minimum age from which the Age Pension becomes available – refer Appendix G for comments;

- Measures to reduce "double dipping" (ie spending superannuation and claiming the Age Pension) – refer Appendix H for comments;

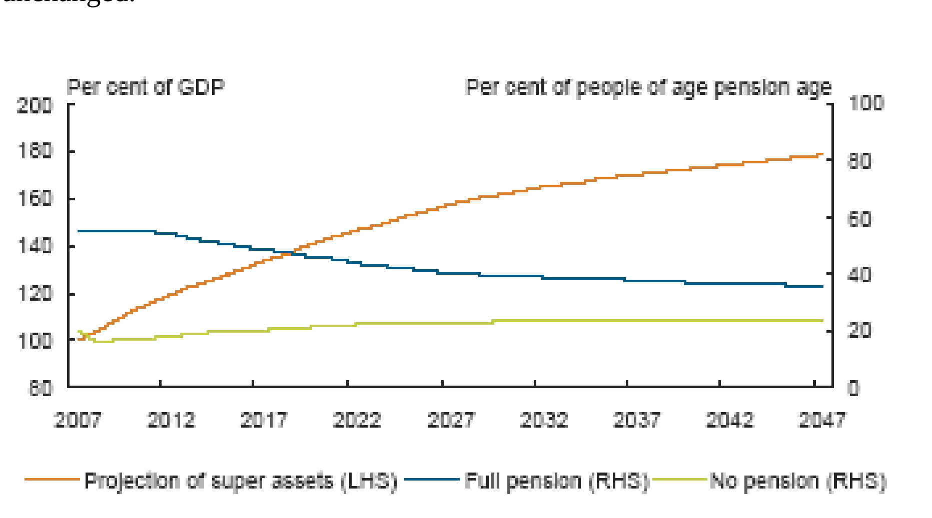
- Tightening of the Means Tests for the Age Pension (and other Social Security benefits) – refer Appendix H for comments.

APPENDIX E

Age Pension - Compulsory Superannuation Scheme

The compulsory superannuation guarantee (SG) scheme commenced in 1992, compelling employers to contribute 3%[3] of employees' basic earnings to their superannuation. This was increased in stages until 2002 when the current rate of 9% was established.

Doubtless the projected cost of Age pensions would have been even higher had the SG system not been introduced. The proportion those over Age Pension Age receiving a full pension is projected to fall from the current just under 60% to less than 40%, although the proportion of the population over 65 not receiving the Age Pension is expected to remain broadly unchanged.



Source – Intergenerational Report 2007

Adequacy of Benefits

It is not the function of this paper to consider the adequacy of the SG scheme in any depth. The following notes are intended to merely provide a general appreciation of current expectations.

It is suggested that the prime test of adequacy of SG scheme benefits is whether, in conjunction with the Age Pension, they produce adequate retirement incomes for people who have been working full time for most of their working lives - ie, say 40 years.

In this regard an adequate retirement income could be considered as one which provides a standard of living commensurate with that enjoyed while working. For this purpose, it is considered reasonable to assume that homeowners have repaid any mortgage and they are no longer needing to support any children.

Consequently, a retirement income of around 65% of gross pre retirement income, or 80% of after tax earnings, have often been suggested by the industry and the Labor party as reasonable targets.

[3] Higher amounts for some employers

Examples are shown below, with projections of superannuation benefits determined using ASIC's calculator and basic assumptions for a balanced investment mix (7.0% pa net of tax investment return, 2.5% pa inflation, 1.5% pa increase in living standards, 0.55% pa asset management fee, and $52 pa administration charge). The figures are shown for a 40 year unbroken career.

Projected benefits are presented in 2008 dollars.

Example: approx	2//3 average Earnings	Average Earnings	1 1/3 average Earnings
Gross Earnings	40,000	60,000	80,000
Less tax	(6,600)	(13,500)	(20,300)
After tax pre-retirement income	33,400	47,100	60,800
9% contribution	3,600	5,400	7,200
Death cover cost	(104)	(156)	(208)
Projected Benefit at age 65	196,000	296,000	395,000
Non income producing, but assessable assets	30,000	45,000	60,000
Superannuation Income 6% drawdown	11,760	17,760	23,700
Age pension	14,368	14,368	14,368
Means Test adjustment	(2,126)	(6,611)	(11,057)
Total retirement income	24,002	25,517	27,011
Less tax	Nil	Nil	Nil
After tax post retirement income	24,002	25,517	27,011
% of pre retirement income			
- before tax	60%	43%	34%
- after tax	72%	54%	44%

For the person on 2/3 average earnings, the result approaches the target level. For the others, the levels of retirement income could not be considered as commensurate with supporting a pre retirement lifestyle.

For a couple on $80,000 pa and $40,000 pa, respectively, their combined after tax post retirement income on the same basis would be **$42,302**, which is **45%** of their after tax pre retirement income. This lower percentage is a junction of the means test's harsher treatment of couples as opposed to two single people.

Arguably, the retirement income drawdown could be increased. However, this could lead to inadequate funding of inflation increases in needs later in life.

It is worthwhile noting also, that investment returns from the standard “balanced fund” are uncertain and that many people are members of superannuation funds with higher fees than the ASIC “standard” of an average industry fund. Consequently, benefits could well be less than those projected in many cases. Moreover, part time workers and those with breaks in their working lives will also receive lower benefits.

The above analysis is only brief, but it clearly suggests that the current contribution rate for the compulsory scheme is insufficient to provide reasonable and reliable retirement benefits for the majority of people.

Increasing Contribution Rate

The possibility of increasing compulsory superannuation contributions and the potential impacts on retirement benefits are examined in Appendix H.

APPENDIX F

Age Pension – Means Test Problems and Principles for Solutions

Principles

It is suggested that the principles for means testing could include some or all of the following:

- Produces a fair outcome for those who have more than the minimal means to qualify for a full pension, but less than the means which would preclude them from any pension.
- Has tests which are simple to apply.
- Assesses those in circumstances which are broadly similar in a similar way.
- Involves a process which, for most people, requires minimal future updating.
- Does not overly discourage saving.
- Encourages the purchase of lifetime pensions.
- Does not discourage working post Age Pension age.
- Has fair rules as between home owners and those who rent.
- Attempts as far as possible to assess all income producing assets in the same way (encourages optimisation of income).
- Indexes asset/income thresholds in line with increases in the Age Pension.

Solutions to current problems identified in this Appendix are intended to follow these principles.

Negative Consequences

Tax and "taper" result in high effective marginal tax rate

The means test "taper" to provide for those not poor enough for a full pension acts as a significant "tax" (currently *40%* of income under the Income Test, in addition to any actual income tax) on the marginally poor.

This leads to a disincentive to participate in the (paid) workforce or, if working, to not declare any earnings.

It also acts as a disincentive to saving by lower paid people. (Under the Assets Test, the marginal "tax" on the pension is equivalent to around *50%* of an expected return of 7.8% pa – and higher if the expected return on the assets is less than this.)

The taper is a consequence of attempting to optimise fairness in the means testing to provide a suitable part pension for those with some means.

A possible (partial) solution is to exempt the Age Pension from personal taxation (in line with private pensions): little tax is actually collected in any case – estimate less than $0.5 billion.

The taper itself could also be reduced. In addition to giving existing part Age Pensioners a little more pension, this would allow more retirees to become part Age Pensioners. The additional cost to government of a reduction to 30% is estimated at around $1.0 billion [4](based on 2006-07 figures).

Invasion of Privacy

Means Testing inevitably requires details of personal income and assets. This forced disclosure represents an invasion of privacy.

This is made worse by the imposition of frequent reviews of information, and potential penalties for inadvertent non disclosure of changing circumstances.

A possible solution is to have a "once only" means test – to be applied at the time of application for the Age Pension.

[Note:

- potential for "managing" assets to "optimise" pension
- need to incorporate ignoring earnings from employment
- potential increasing poverty where other assets not well managed]

Issues

Discouragement to Continue in the Workforce

The availability of a means tested Age Pension from age 65 (currently 63.5 for women, but gradually being increased to 65 over the next 6 years) acts as a discouragement to continue working. Alternatively, it encourages non disclosure of earnings, and working in the "black economy".

A possible solution (explored further in Appendix G) would be to ignore earnings from employment in carrying out the means tests. It has been estimated that this would cost around $1 billion in the current year. This compares with the Budget estimate for total Age Pension costs of $24 billion. In practice it could reasonably be expected that the economic benefit from the likely increase in the work participation rate would offset the relatively small cost of not assessing employment earnings.

Discouragement to Save

The results of saving for retirement will be subject to the means tests, whether in the form of superannuation or otherwise.

[4] Assuming a) for those currently receiving a part Age Pension – the average assessed income is $9,187 and b) of those currently not receiving the Age Pension, 50% have income which falls within what would become a new allowable income range to receive benefits.

For those eligible for a full or part Age Pension, marginal income arising from saving could suffer a means test “tax “of 40%, plus possibly some income tax.

For richer people the tax benefits of superannuation are likely to exceed any “loss” of part Age Pension benefits. For poorer people, the superannuation co-contribution system may be the only truly (financially) beneficial form of voluntary savings.

A possible solution would be to extend the co-contribution system to allow higher contributions for poorer people. (This could be paid for some reduction in the superannuation tax benefits for richer people).

Encouragement to “Double Dip”

Saving for retirement is encouraged by the government through compulsory contributions and tax concessions for voluntary contributions. The general purpose is to alleviate the growing cost of Age Pensions in a climate of the ageing of the population with increasing longevity.

Yet the structure permits the expenditure of superannuation benefits without restriction or tax penalty.

Consequently many retirees “double dip”, ie, spend their superannuation and then go on the Age Pension.

A possible solution is to provide encouragement to retirees to purchase lifetime pensions, or some form of discouragement from early run down of superannuation benefits – for example a tax on the excess of withdrawals in any year over a prescribed maximum percentage of account value (which increases with age).

Complex Administration

Means tests are administratively complex – they are difficult for Centrelink staff to administer and pensioners to understand.

Many of the problems are as a result of inconsistencies in the rules.

Solutions to some areas of complexity can be found by eliminating inconsistencies.

Anomalies

Inconsistent Assessment Rules – Two Tests

There is an assets test and an income test – with the lowest pension resulting being adopted. Different types of asset are assessed differently – which leads to “perverse” decisions being made with regard to purchasing, holding or selling assets to maximise benefits.

A possible solution is to have just one test – an income test, along the lines of the current “deeming” rules. First, assess all assets (other than the main residence and lifetime annuities) in the same way – ie by value. A suitable investment return (“deemed” rate) is then applied to determine the income from these assets for income test purposes.

This should lead to a focus on liquid assets which can generate actual income or be sold as necessary to realise capital gains to support needs, or purchase a lifetime annuity.

The income thresholds under the current Incomes Test before the proposed test begins to "bite" may need to be increased to accommodate non income producing personal effects and family heirlooms which pensioners may reasonably not wish to sell to generate income.

Indexation Inconsistencies

Means tests thresholds are only indexed to CPI, whereas pension rates have been increased in line with earnings for many years now. The thresholds have therefore become progressively tighter (in a real sense as community living standards rise) requiring occasional arbitrary adjustment.

A possible solution is to automatically index thresholds in line with pension rate increases.

Assets Test Threshold Differential for Non Homeowners – But not under Income Test

Non homeowners can claim a part Age Pension if their assets are between $296,750 and $664,750. However, the range for homeowners is only from $171,750 to $540,250. (For couples a similar differential applies.)

The higher assets test thresholds for non home owners is understood historically to have reflected their need for additional income to cover rent? – although this is inconsistent with the income test where there is no homeowner/non homeowner threshold differential.

If Rental Assistance was increased to realistic levels (refer Appendix I), there may be no argument for the higher non homeowner assets test threshold.

APPENDIX G

Options for Reform – Increase Workforce Participation

Increase Workforce Participation Rates

The previous government suggested that its preferred solution to the challenge of an Ageing Population, and the increasing Budget deficits projected in the second Intergenerational Report (IGR), was to implement policies designed to grow the economy more quickly and that the best way of doing that was to increase workforce participation rates[5]. The new government has so far shown similar thinking[6].

The IGR noted that workforce participation rates for the 15 to 64 age group had increased in the 5 years since the previous report. A further small increase is forecast over the next 40 years.

The report noted that Australia lies 12th in the list of 30 OECD countries – with UK, US and New Zealand ahead.

One particular group where increase has taken place in Australia is the “over 55’s”. However further significant increase should be possible.

The average workforce participation rate for those in the 55 to 64 age group is currently only 59% (the IGR noted that the rate for New Zealand was over 70%!) Our average for the 65 to 69 group is 21%. The employees in these age groups include a large number of part time workers. Arguably there is almost certain to exist significant underemployment in this group.

A major reason for the underemployment of over 55’s is the clear favouritism of many employers to allocate full time jobs to younger applicants. While probably illegal in most cases, “ageism” of employers exists across a wide range of sedentary jobs which could readily be carried out by over 55’s. And, of course, this situation is exacerbated by employers seeking to replace older employees with younger ones requiring lower salaries.

An arguably necessary way forward is for governments at all levels to take the lead. This could be pursued both through financing generous retraining schemes and actual employment of more over 55’s in the public service.

Currently, many fit retirees perform voluntary work assisting the less fit in the community. Ideally, many of these jobs would be properly rewarded by the community through the Social Services budget. Apart from appropriately recognising the worth of such work, it would assist in the better understanding of the “true” work participation rates for the over 55’s, and allocating the “correct” social security benefits.

Increase Pension Bonus Scheme Payments

The Pension Bonus Scheme provides a bonus for those deferring their claim for the Age Pension, based on the level of pension to which they are entitled at the end of the period they have chosen to defer it.

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[5] Treasury, “Australia’s Demographic Challenges” (2004)
[6] Launch of the Discussion Paper on Australia's Future Tax System 6 August 2008

Currently the Pension Bonus Scheme provides the following payments:

Years deferred	Bonus (single person)	Percentage of Pension Payments "not received"
1	$1,336.40	9.4
2	$5,345.50	18.8
3	$12,027.40	28.2
4	$21,382.10	37.6
5 or more	$33,409.50	47.0 (5 years)

This compares with the Age Pension for a single person of $14,216.80 per annum. Clearly the bonus is unattractive as a direct incentive to defer taking the Age Pension.

The scheme is of benefit to those who continue to work after reaching Age Pension age, and arguably it provides an incentive to do so.

However, the relatively poor level of benefit (miserly after one or two years, and reaching a maximum of around $33,000 only after 5 years for a single person then eligible for the full pension, compared with potential pension payments totalling over $71,000), the uncertainty of its amount for any person until the "end date" means test, and rather complex administrative procedures, have combined to generate a relatively poor take up rate.

A possible solution is to revamp the scheme to make it more attractive in terms of the amounts of bonus and its accessibility. Alternatively the reward for deferment could be in the form of an increased annual pension.

Another possible solution is to scrap the scheme, and focus on encouraging continued participation in the workforce by simply eliminating employment earnings from the means test.

Eliminate Personal Exertion Earnings from Means Test

Another incentive to increase work participation is to ignore earnings from personal exertion in the means test.

An estimate of the cost of this to the Government for the current year is around *$1 billion.* This compares with the Budget estimate for total Age Pensions currently, of *$24 billion*. It could reasonably be expected that the economic benefit from the likely increase in the work participation rate would offset the relatively small cost of not assessing employment earnings.

The cost of eliminating wages and salaries from the Age Pension income test is much lower than abolishing the income test (or indeed moving to a universal pension).

Presently, most part rate pensioners have had their pensions reduced due to the income test (around 80%), rather than the assets test. This group have assessable earnings from three main sources:

1. Deemed Income and other income from investments
2. Superannuation
3. Wages and salaries.

There is evidence that assessed income comes from the first two groups and not wages and salaries.

- Surveys suggest the most common form of income is from savings and investments usually from banks[7]
- In June 2004, only 6.1% of male and 7.4% of female Age Pensioners were in the workforce[8]. This compares with 32% of all Age Pensioners who have their income reduced due to the income test.
- The main reasons for the fluctuating impact of the income test from year to year is the impact of savings and investment returns

Assuming around 126,000 Age Pensioners (20% of the 630,000 income tested part rate pensioners) have had reductions due to personal earnings (with an average annual pension reduction of say, $3,300 each[9]) - this suggests a cost of around **$400m** for this group.

Further **cost** would arise in respect of those not currently receiving any Age Pension due to wages and salary (there were around 230,000 employees over the age of 65[10], with 140,000 of these being Age Pensioners). If 75% of this remaining eligible group of around 90,000 claim an average pension of say, $9,000pa, this additional cost would be **$600m.**

There would, of course, be no additional cost for those already working and not declaring their income to Centrelink!

Likewise, there would be no additional cost to the government for those currently receiving the Age Pension who decide to re commence employment!

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[7] DFAC "Trends in income and living standards of older people" research paper # 6 (2000)
[8] DFAC "New Age Pensioners Trends in Wealth" (2005)
[9] FaHCSIA Annual Report 2006-07
[10] ABS Labour force 6105 (April 2007)

Increase the Age Pension Age

Clearly, increasing the minimum eligibility age for the Age Pension would automatically increase the number of individuals "available for work" after age 65. At the same time there needs to be a reasonable rationale for doing so.

It would seem that there should be a sensible balance between the number of years that individuals are expected to work and pay taxes, and the number of years those who have been unable to fully provide for themselves are supported when they are unable to work.

Improving technology and increasing work efficiency have combined to provide the prosperity which has enabled retirees to continue to be supported as their number and longevity have increased.

However, at some stage, it seems reasonable to expect the above working/non working balance in a period of increasing longevity to be addressed by increasing the age to which people are expected to work if able to do so – ie, the minimum age for eligibility the Age Pension, or the Age Pension Age.

A number of countries are already pursuing this course, notably the UK, Germany and Japan.

A recent paper from CEDA, written by David Knox, noted this and suggested that Australia should also move its Age Pension Age. Perhaps as expected, media journalists who write articles and are unlikely to personally need the Age Pension, supported the initiative, while reporters whose jobs are to find people to oppose new ideas, did so quite successfully, and the politicians ducked the issue.

History of Age Pension Age

At the same time, it seems reasonable to project that the age at which people could be eligible for a state provided pension without a work test will be increased in the future.

The concept of retirement at age 65 (for males) has been accepted in most western countries since early last century.

The provision of a state funded age pension was introduced at a federal level in Australia in 1908 (first paid in 1909) for males and females from age 65. This was later lowered to age 60 females from 1910.

At that time the expectation of life of male retirees was 11.3 years. 40 years ago it had increased to 12.2 years, and is now 17.7 years (ignoring future expected mortality improvements). Current expectations are that it will continue to increase as a result of advances in medical science.

In 1908, the proportions of males born that were expected to survive to their 65th birth was 49%. Today that figure is 85% and rising.
The Age Pension Age for females is currently 63 ½, and is being increased gradually to age 65. This will apply to retirees from 2014. (For DVA pensions it is currently 58 ½, and being increased to 60 over the same period).

The current expectation of life for 65 year old females is 21.1 years, compared with 12.9 years in 1908.

Arguably, the Age Pension Age for males was fixed at age 65 in 1912 partly because many people of this age were no longer able to work. Today, only around 58% of males aged 60 - 64 are currently in work, although many more would work if jobs were available to them. It seems likely that this position would also apply after age 65, at least for a few years. (Indeed some 28.5% of those age 65 - 69 continue to work even though many would be eligible for the Age Pension.)

While not welcomed by those immediately affected, increasing longevity suggests that increasing the minimum age for the Age Pension is not unreasonable. Moreover, there would be a *triple* economic benefit. Government costs would be reduced, and more people would be net contributors to the economy, and they would increase their own superannuation for their eventual retirement. Arguably for some, there could be an increase in their well being and sense of “worth” or fulfilment.

Need to Provide Advance Notice of Pension Age Increase

However, these may not be sufficient arguments for the currently middle aged people who have been encouraged by superannuation industry promotions to plan for an active early retirement to enjoy their Autumn years, rather than later retirement.

Any increase in the Age Pension Age will therefore need to be flagged many years in advance of its actual implementation. Apart from dealing with the likely general outrage, fanned by the press, it will be necessary to reassure people that the disabled and those unable to find work will not be disadvantaged.

A Reasonable Age Pension Age

Determining a reasonable Age Pension Age requires consideration of the “balance” between years working and years retired.

In 1908 when state funded retirement pensions were first introduced, this might have been 50 years working, to an average 11 years retired, for males. Currently it is more like 40 years working, (allowing for average years of tertiary education and years out of work), to at least 18 years retired for males.

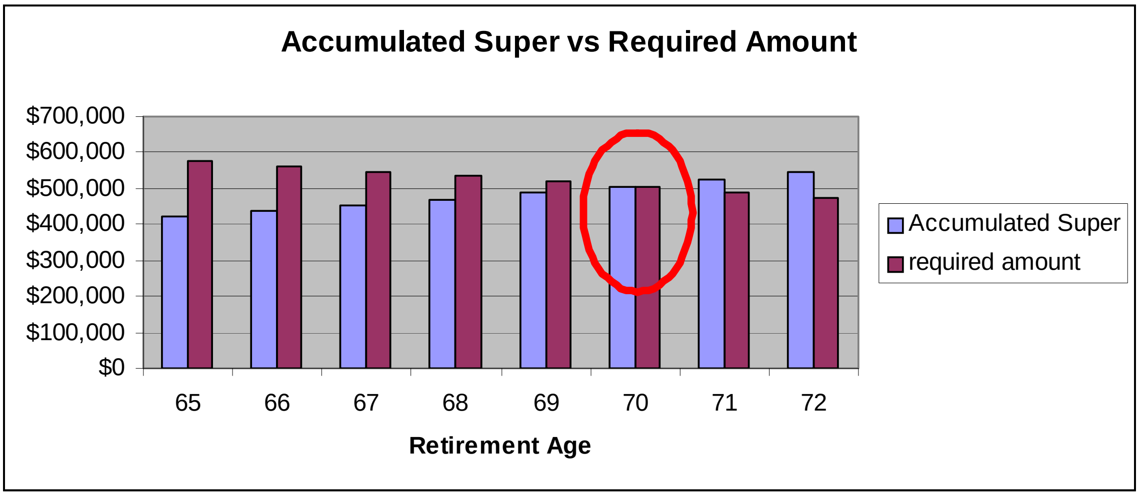
It is accepted as reasonable that increasing prosperity should have allowed increased “retirement years” relative to “working years”. However, as discussed above, the increasing costs expected from the ageing population suggest that the current position should be reviewed.

The “work/retirement balance” principle for determining an appropriate retirement age might be considered as that age where the accumulation of a reasonable level of contributions provides sufficient proceeds to purchase an adequate private lifetime pension.

If we take 15% of earnings as a possible reasonable level of contributions, and 65% of gross pre retirement earnings as an adequate retirement income (as suggested by industry bodies, including this Institute, and supported by the Labor party), then we can develop an equation of value with the retirement age as the unknown.

To provide an example, we have assumed: 7% pa investment returns (including imputation credits from Australian equities) after expenses, together with 4% pa salary inflation and the use of current “improving mortality” annuity rates, commencing employment at age 25 continuous full time working years thereafter, a $50,000 annual salary, and current lifetime annuity rates indexed at 4% pa to maintain expected increases in living standards.

On this basis, we have found that age 70 currently provides the above suggested equivalence of value – across both sexes. The table below shows the results for men, with the accumulated amounts in super[11] versus the annuity values [12]of 65% of pre retirement earnings (the "Required Amount").



A retirement age of 70 would provide a "years working to years retired" balance ratio of 45 to 15 on the assumptions made.

If age 70 is deemed to be an appropriate retirement age for those able to provide for themselves to ensure adequate retirement provision, then perhaps this is a reasonable age for the community to adopt as the Age Pension Age, ie the age from which a state funded pension is paid to those with inadequate provision for themselves.

Affordability

While a logical calculation can be made for the Age Pension Age, based on the accumulation of contributions and adequacy of lifetime income, it is still necessary for the government of the day to be able to justify the cost to taxpayers.

The cost will depend, amongst other things, on the number of workers and retirees at the time.

The next 10 to 30 years will see a significant ageing of the population arising from the high fertility rates prior to 1960 and the significantly lower fertility rates since time.

The proportion of "over 65's" is projected in the second IGR to increase from 13.4% to 25.3% over the next 40 years.

One estimate made by the ABS of the proportion of over 70 year old's in 2047 is 21.1% (compared with 9.5% now)[13]. Bearing in mind the expected fall in the proportion claiming the Age pension, adoption of age 70 as the Age Pension Age may result in the cost being "affordable". It would be necessary to carry out more detailed calculations.

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[11] Based on ASIC Fido super calculator - $52pa fee + 0.55% asset fee , $78pa insurance premium

[12] Based on 10 guarantee period, 67% reversion to spouse – primary male annuitant being 2 years older than female spouse, ALT2000-02 with 105 year mortality improvement.

[13] ABS 3222.0 "Population projections 2004-2101" (2006 Reissue) – "Series A" which the authors believe is the most realistic set of assumptions used by the ABS

Moving to an Increased Age Pension Age

Whatever (new) age is selected as the likely desired Age Pension Age in 2047, an announcement to this effect should arguably be made as soon as the decision/expectation is determined. This will ensure that those who will be impacted will have plenty of notice and be able to plan accordingly.

Moving to the targeted Age Pension Age would be flagged as taking place over a period of years. If age 70 is the ultimate target, then phasing in can be made faster or slower depending on projected budget deficits. Two examples are:

Age Pension Age	(1) Year	(2) Year
65.5	2020	2029
66	2023	2031
66.5	2026	2033
67	2029	2035
67.5	2032	2037
68	2035	2039
68.5	2038	2041
69	2041	2043
69.5	2044	2045
70	2047	2047

In this regard, it is worth noting that, if compulsory superannuation contributions are increased to 15% of earnings, the additional contribution taxes would reduce the projected budget deficits. The phasing in of their implementation may well therefore be a factor in the determination of the phasing in of any increase in the Age Pension Age.

Reframe Age Pension Age – "Soft Compulsion" / Blended approaches

There are several ways that state pension age can be increased that are not the simple ratcheting up of the minimum eligibility age. Blended approaches can be used where people are still eligible at 65 for some payment, but the default age is increased. Behavioural economics tells us that how the framing and description of choices impacts on individuals' decisions (and also shows the people are often simply do not make choices and use default options – soft compulsion).

Some of these blended approaches have the advantage of allowing governments to argue that that people can still receive the Age Pension at 65.

Examples are:

(a) Make the default age for pension commencement 75 (say) at current pension levels and offer an actuarially reduced pension for those commencing an Age Pension below 75.

(b) Make the default age for pension commencement 75 (say), with an actuarially increased pension if taken from that age (or from ages between 66 and 75) and leave the pension at its current levels for those commencing at age 65.

(c) Utilise one of the above options, but add further eligibility criteria that require a special application to receive an Age pension below age 75 - such as disability grounds or impose explicit mutual obligation requirements (see below).

Equalisation of Social Security Benefits

At the present time, Social Security benefits for those over 55 but under Age Pension Age without jobs vary according to whether the person is disabled or simply unable to find work. Basic benefits per fortnight are $437.10 for those seeking work (Newstart Allowance). These compare with $546.80 for the Age Pension / Disability Support Pension.

Arguably all such "unemployed" people have similar living needs and should receive the same benefits (subject to means testing).

It is speculated that the discrepancy between the Disability and Newstart payments may help explain the very high levels of number of people receiving Disability Support Pensioners in comparison to the number receiving of unemployment benefits (around 21.5% of the total male population aged 60-64 were in receipt of the Disability Support Pension in 2004 this compares with 2.9% for the Newstart benefit)[14].

This issue is exacerbated if/when the government increases the Age Pension Age. While the basic benefits for the disabled are the same as those for the Age pension, "seeking work" benefits are somewhat lower and "fringe benefits" vary between all three categories.

It is suggested that, in order to "sell" any increase in the Age Pension Age to the community, the government will need to align all these benefits – at least for those over age 65 (63 ½ for females).

[14] DFAC Statistical paper No3 & ABS 3222.0 "Population projections 2004-2101" (2006 Reissue)

APPENDIX H

Options for Reform – Options to Reduce Government Costs

Increase Compulsory Superannuation Contributions

Many observers, including the IAAust, have noted that contributions of 9% of earnings are unlikely to provide adequate retirement benefits for the vast majority of the population – even after including the Age Pension.

The Labor government, prior to 1996 proposed that the 9% should ultimately be increased to 15%, including 3% paid by the employee. Various industry bodies have also suggested a 15% target. A range of commonwealth public servants enjoy the benefits of a contribution rate of 15.4% - this being the rate determined as equivalent to the cost of their previous, but now closed, defined benefit schemes. This rate is now proposed to be adopted for commonwealth politicians and judges.

Clearly, all these people consider that contributions of (at least) 15% are required to provide a reasonable level of retirement benefits.

The results of extending the examples in Appendix E are as follows:

Example: approx	2//3 average Earnings	Average Earnings	1 1/3 average Earnings
Gross Earnings	40,000	60,000	80,000
Less tax	(6,600)	(12,900)	(19,200)
After tax pre-retirement income	33,400	47,100	60,800
Projected Benefit at age 65 – contribution rate of 9% of earnings	196,000	296,000	395,000
15% of earnings	333,000	501,000	669,000
Non income producing, but assessable assets	30,000	45,000	60,000
Superannuation Income 6% drawdown	19,980	30,060	40,140
Age Pension	14,368	Nil	Nil
Means Test adjustment	(7,469)	-	-
Total retirement income	26,879	30,060	40,140
Less tax	Nil	Nil	Nil
After tax post retirement income	26,879	30,060	40,140
% of pre retirement income			
- before tax	67%	50%	50%
- after tax	80%	64%	66%

These results would seem to be much more acceptable as representing retirement incomes commensurate with pre retirement earnings – with a margin for the uncertainty of the outcome. (The higher after tax result for the 1 1/3 average earner, compared with the average earner, arises because the superannuation drawdown is not taxed, following the rather generous Simpler/Better Super changes from 1 July 2007.)

If the compulsory contribution rate were increased to 15%, then the projected cost of Age pensions in the year 2047 would be rather less than the 4.4% GDP projected without such an increase.

The increase to 15% could be phased in over a period of years. Alternatively, a system of "soft compulsion" could be introduced for some or all of the increase.

The above comments focus on a retirement age of 65. If the minimum eligibility age for the Age Pension were raised, the longer working lifetime could mean that a lower contribution rate than 15% would produce adequate retirement benefits.

Scrap Superannuation Fund taxes, and Compulsory Contribution need only increase to 10% of Earnings

Finally, it is worth noting that, if the contribution and investment income taxes are withdrawn, broadly similar retirement benefit outcomes would be achieved by increasing the compulsory contribution rate to just *10% of earnings.*

The Government could recoup the tax lost by reducing the personal tax concessions on contributions – perhaps to a single rebate rate, which would then make them fair as between people on different salary levels.

Increase Compulsory Superannuation Contributions <u>and</u> Increase Minimum Age Pension Eligibility Age

If compulsory contributions are increased to 15% of earnings, and the Age Pension Age increased to 70, the normal expected working life may extend to 45 years. The 2/3 rds average earner would then accumulate ***$402,000*** on the same basis as shown above. This would result in the Age Pension being reduced to only $4,208 in that example and being reduced to nil in others.

Possibly by the 2060's, most of those reaching Age Pension Age will have accumulated sufficient superannuation not to require any Age Pension.

The focus of the affordability of Social Security benefits may have then moved more strongly to the disadvantaged – in line with the expectations of an advancing civilisation. People over age 65 and under 70 will either be working, or receiving a disability support pension or unemployment benefits. The mood of the community could be moving to the view that the fit should only fully retire when they have accumulated sufficient funds to do so.

Possibly the Age Pension Age will simply be viewed as the age at which all individuals are *assumed* to be disabled – for administrative convenience.

Possibly the concept of a state funded *retirement* pension will eventually disappear.

All this speculation however, depends on the elimination of "double dipping".

Double Dipping

There appear to be mixed feelings in the community as regards the spending of superannuation money, and then, if it has run out, claiming the Age Pension.

Some take the view that, if they have personal funds at retirement which are insufficient to provide a lifestyle to which they aspire throughout their retirement, then it is perfectly reasonable to enjoy such a lifestyle until the funds are exhausted, and then fall back on the Age Pension. After all they have paid taxes throughout their working lives; hence they are, in principle, *entitled* to an Age Pension.

Others take the view that “double dipping” is a rort. Certainly, the generous superannuation tax concessions would reasonably be expected to result in retirement benefits which would be used to reduce government expenditure on Age Pensions. Arguably, whatever superannuation funds are available should last over the lifetime of the retiree. Only if the assets held and the income drawn fell below the means test thresholds would a part Age Pension be claimed.

The existence of a preservation age for superannuation benefits which is less the Age Pension Age encourages the first approach above.

The superannuation preservation age is to be increased from age 55 to age 60 in stages over the period from 2015 to 2024. For this reason (and the availability of tax free benefits) many people see age 60 as a good target age at which to retire. This would allow enjoyment of some years of retirement while still healthy – and fitting the image of financial planning advertisements promoting the “cult” of early retirement.

Consequently, “double dipping” of retirement assets is subject to little restriction by the Government. The extent to which it causes Age Pension costs to be higher than if there were restrictions is uncertain. However, it seems likely that some measures to contain the effects will need to be considered as Age Pension costs rise with “baby boomer” retirements.

Possible Measures to reduce Double Dipping

1. Require (some) superannuation assets to be used to purchase an indexed lifetime pension up to an income equal to the Age Pension.

2. Extend the tax on superannuation investment income and capital gains from assets supporting accumulation benefits, to income and capital gains from assets supporting pension benefits – except where the pension was a non commutable lifetime pension. This would raise annual revenue of around $2 billion currently, as well as encourage purchase of lifetime pensions.

3. Introduce a tax to be paid on superannuation withdrawals in any year over a prescribed maximum percentage of account value at the beginning of the year. The maximum percentage would increase with age.

4. Encourage the purchase of the Age Pension (or balance up to the full Age Pension in the case of those entitled to a part Age Pension). This could be pursued through the purchase from a life company where the Government provided some support for the inflation risk (and possibly the longevity risk). Alternatively the Government could accept the purchase directly. This suggestion is developed further in Appendix K.

Tighten the Means Tests

Over the past decade, the means tests have been relaxed in a number of ways. The main ones were reducing the "taper" rate under the income test from 50% to 40% (in 2000), and the availability of a more generous assets test treatment for complying pensions or annuities (in 2005).

From 1 July 2007, the (previous) government legislated a further relaxation of the assets test taper to effectively permit home owning couples with up to $825,500 (excluding the family home) to be able to claim a part Age Pension. (Previously the top threshold was $536,000.) The new figure was increased to **$856,500** from 1 July 2008. The corresponding top threshold for singles is **$540,250.**

Arguably, these initiatives represented Liberal/National party policy in wishing to maximise the incentives to voluntarily save for retirement (or minimise disincentives).

An alternative view would be that providing part pensions to those with more than $500,000 represents "middle class welfare", and the money could be better spent on the genuinely disadvantaged.

Restore "taper" to 50%.

To save costs, the incomes test "taper" could be restored to 50%. (Arguably, this would make it more consistent with the "taper" under the Assets test, which, assuming an investment earnings rate of 7.8% pa, is 50% of income generated).

This move could be softened by a decision to scrap income tax on the Age Pension. In practice, few pensioners pay any income tax, so that the Government could claim that, after the changes the maximum effective rate of "tax" (ie, including means test taper) on marginal income is just 50%.

Estimated savings are $500m (in 2006-07 dollars)[15]

Reduce Assets Test Thresholds.

The assets test thresholds are inconsistent with those for the incomes test. A single homeowning retiree can have assets of $171,500 before losing any Age Pension. It is believed that, for such people, non income producing but assessable assets tend to represent about $30,000 to $40,000 of this. This leaves say, $140,000 earning say, 6% pa – ie producing an income of $8,400 pa.

The equivalent minimum threshold under the incomes test, of $3,588, appears inconsistent with this. It may be considered reasonable therefore, to reduce the assets test threshold to from the ***$171,500*** to around $3,588/.06 + $40,000 = approx ***$100,000.*** The equivalent threshold reduction for couples would be from the current ***$243,000*** to $6,240/.06 + $70,000 = ***$174,000***.

Estimated savings are more than $400m (in 2006-07)[16]

[15] Assuming for those currently receiving a part Age Pension – the average assessed income is $9,187. This is consistent with the cost impact of cutting the taper rate from 50% to 40% shown in the "The Howard Governments Plan for a New Tax System"(1998)

[16] Assuming the 20% of part rate pensioners where the assets test is applying have full reduction of their pension by 3.9% x ($171,500 less $100,000). Further savings may occur for some recipients where the income test is currently applying instead of the assets test.

Use personal assets before claiming any Age Pension

A possible approach to tightening means testing is to require the use of personal assets in excess of the current asset threshold for a full Age Pension, to fund retirement needs before access to the Age Pension is permitted. That means that no part Age Pension would be available. Once personal assets had fallen below that threshold ($171,750 for single home owners and $296,250 for single non homeowners), the Age Pension would be available – and payable at the full rate.

Undoubtedly such action would be unpopular – although perversely it appears to be encouraging double dipping!   It may have a similar impact to simply increasing the Age Pension Age.

To avoid actually spending personal assets, the retiree could have the option of purchasing a lifetime annuity/pension. Consequently, in conjunction with this alternative, the proposal could possibly result in reducing the cost of double dipping while simplifying means testing – as well as tightening the means test.

Estimated savings $750m pa (in 2006-07 dollars)[17]

[17] Assuming that of the approx 550,000 in the 65-69 Age group of Age Pension recipients around 55,000 would be exempted out of the pension due to not having used up their assets (ie approx 25% of 65 and 66 year olds)

APPENDIX I

Age Pension and "Fringe Benefits"

Fringe Benefits

There are a plethora of concessions and allowances available to Age Pensioners (and in some cases, to other Seniors), provided by the federal and state governments.

Many of these "fringe benefits" are paid to assist meeting specific types of expenditure – eg telephone costs, council rates, water rates.

Certain of the federal government "fringe benefits" are paid as "supplementary cash" support to all Age Pensioners. These are:

	Current rate for single pensioners, and total for couples
Pharmaceutical Allowance	$5.80 per fortnight
Utilities Allowance	$125 per quarter
Seniors Bonus	$500 per year

Arguably these could be incorporated into the Age Pension to provide a single fortnightly pension payment. Without other changes, this would have the effect of increasing the thresholds permitting a part Age Pension slightly, while providing existing pensioners with the same income. However the cost would be small, as the number of additional pensioners would be small and they would only be receiving a small part pension.

This would represent some simplification of the system. The move would also provide better certainty of payment for pensioner budgeting purposes.

For the purposes of comparisons with standard of living measures in this paper, Age Pension amounts are shown inclusive of these supplementary cash" allowances.

Retention of Allowances separate from Age Pension

It is appreciated that the federal government may wish to retain some flexibility by keeping the allowances separate from the Age Pension, eg, they can be easily varied, or eligibility rules can be changed, on a year to year basis.

Indeed, the view could be taken that eligibility for the allowances should be means tested so that full allowances are only paid to pensioners with minimal resources receiving the full Age Pension. Those with sufficient resources that they only qualify for a part pension, could have their allowances reduced in the ratio of their part pension to the full pension.

This would enable the government to increase the nominal total value to focus the benefit on the poorer pensioners without any impact on the current government budget.

Rent Assistance

Current maximum levels of Rent Assistance are **$53** per week for single pensioners and **$47** for couples (in total) – yes, less for couples! (FaHCSIA have advised that this is due to their attempting to follow the policy established in 1993, whereby “single pensioners and couples who are wholly reliant on social security payments pay a similar proportion of income on rent before qualifying for Rent Assistance”).

These maxima are woefully inadequate when compared with current private market rents. Even in outer suburbs of Sydney, rents for one bedroom apartments near shops and public transport are around **$180** per week.

Homeowners incur some housing costs. Consequently it is reasonable to assume that some level of these in included in the Age Pension and that this should be allowed for in determining maximum levels of Rent Assistance, (perhaps after also allowing for council and water rate rebates available to homeowners),. However, it is clear that significant increases are required to provide a standard of living for renters approaching that for homeowning Age Pensioners.

To limit government expenditure, revised levels of Rent Assistance could be targeted at those most in need. For a part Age Pensioner the nominal Rent Assistance available could be reduced in the ratio of the part pension to the full pension.

APPENDIX J

Abolish Means Test Completely – Universal Age Pension

Proposal

- An Age Pension paid to *all* eligible residents.
- No assets tests or income tests apply (ie a universal pension)
- Age Pension exempt from income tax (just like super benefits)
- Cost is met from general revenue which is augmented by extending superannuation tax to investment income on pension assets, and removing the CGT discount under superannuation, personal income and trusts tax regimes.

Why a Universal Age Pension?

As mentioned in Appendix C, many of the reasons why the Age Pension fails to meets its objective of being an efficient pillar of Australia's Retirement Income system relate to the means tests.

The means tests distort savings and investment behaviours, are administratively costly, and discourage workforce participation. They can make planning for retirement very difficult.

Australians accept universally provided benefits for health needs. Australia's healthcare system, Medicare, is universal and not subject to means testing. This is accepted (and indeed is highly thought of) by Australians despite benefits being available to the wealthier members of the community. This arrangement is perceived to be reasonable because there is a fair tax arrangement to fund the benefits.

Due to the tax arrangements (including the notional "Medicare Levy"), wealthier people contribute more on a dollar basis to funding Medicare, but the benefits are the same for everyone.

The proposals in the section are consistent with this philosophy of fairness achieved through taxation.

This proposal for Universal Pension is Different!

There have been other proposals for a Universal Age Pension in Australia. In fact, Australia has twice had legislation pass through parliament for a contributory social insurance scheme which included it. In 1929, the legislation was never proclaimed (following a change of government). In 1938, the scheme commencement was twice postponed and then finally lapsed in 1939. In addition, in 1975 the Whitlam government abolished the means test for those over age 70; however, an assets test was reintroduced in 1985

Many other OECD countries' contributory universal social insurance systems are essentially salary based defined benefit schemes.

In the 1990s the IAAust proposed making the Age Pension universal and imposing a tax on pensioners' income. (1994 IAAust submission to Senate Inquiry).

This proposal is different:

- The cost of the universal pension is met from general consolidated revenue.
- There are no complex additional tax arrangements specifically to clawback the universal pension from individuals.
- Therefore the proposal is simpler from the pensioner's perspective.
- The measures to increase consolidated revenue provide tax revenue largely from wealthier people -both those currently in employment and superannuation fund pensioners.

How Much does Abolishing the Means Test Cost?

According to the (then) Department of Family and Community Services, the means test saved the Government around $6-$7bn in respect of Age Pensions in 2002[18]. ASFA recently stated that abolishing the means test would cost in excess of $6.5 billion a year[19].

Based on the latest published statistics (2006-07)[20];

- Around 705,000 people of Age Pension age (who are eligible residents[21]) are not currently receiving any pension (missing out on an average pension amount of $12,400)
- Around 780,000 people are receiving a reduced age pension due to the income or assets tests. On average the reduction in the pension is around $3,300pa.

If the Age Pension was paid in full to these two groups, the increased expenditure in 2006-07 would have been in the order of $11.3bn higher (around 1.1% of GDP). This figure needs to be reduced as some of the extra expenditure has already been incurred with the Better Super changes (increasing the assets test taper rate from 1 September 07). The Better Super impact is around $0.7bn[22], **therefore the cost of a Universal Age Pension under the current rules would be around $10.6bn (1.0%of GDP).**

In 1998, Treasury's RIM group did some work forecasting the additional cost of a Universal Age Pension. The results were that the additional cost would be around 0.8% of GDP in 2010-11 rising to 3.5% of GDP by 2050.

As mentioned in Appendix D, we believe that Treasury's projections used in the Intergenerational report may overstate the impact of means testing in the future due to the way thresholds are assumed to be indexed. So the impact in our view is likely to be less than that 3.5% of GDP previously forecast by Treasury.

The cost of removing the means tests is likely to vary by age group. The table below shows the number of Australians at 30 June 2004 at different ages receiving the Centrelink pension, Veterans pension, and not receiving any pension.

[18] DFACS submission to 2002 Senate Inquiry into standards of living in retirement.
[19] Clare, R "The interaction of the Age Pension and superannuation in provision of Australian retirement incomes" (2007)
[20] FaHCSIA Annual Report 2006-07
[21] There are actually around 740,000 people of eligible age pension age. We have assumed that roughly 5% of these are not eligible due to residence requirements (in the 2006 census data, there were approx 30,000 new migrants over the age of 55 during the period 2002-2006) [table 3.1 34150DS0018 Migrants, 2006 Census of Population and Housing, Australia].
[22] FaHCSIA Portfolio Additional Estimates Statements for 2006-07, adjusted if applied in 06-07 year

Age group	Centrelink Age Pension	Veterans Pension[23]	No Income Support	Total Population	% Receiving Income Support
Female only 63 & 64	127,004	2,599	38,845	168,448	77%
65–69	510,525	17,645	218,230	746,400	71%
70–74	472,315	27,524	128,561	628,400	80%
75–79	364,732	76,812	108,156	549,700	80%
80–84	206,040	124,435	54,325	384,800	86%
85–89	118,667	41,679	33,354	193,700	83%
90 or more	70,329	8,723	22,848	101,900	78%
Total 2004	1,869,612	299,416	604,320	2,773,348	78%
Total 2007	1,953,686	252,966	741,069	2,947,721	75%
Difference 2004 to 2007	84,074	(-46,450)	136,749	174,373	

Funding the Reform – Increasing Tax on Investment Income and Capital Gains

A combination of increases in taxes on investment income and capital gains is proposed to fund the extra $10.6bn in Age Pension expenditure. The tax increases proposed are:

- Remove the capital gains tax discount on superannuation funds ($1.5bn[24])
- Tax the assets of superannuation pension assets in the same way as assets in the accumulation phase ($3.0bn[25])
- Remove the capital gains tax discount under the personal income and trusts regimes ($6.9bn)

All figures above are in 2006-07 dollars.

The additional tax revenue from these measures is likely to grow faster than GDP[26] and therefore be effective (at least partly) in meeting the growth in Age Pension expenditure as a result of removing the means test and the ageing of the population.

Any future Age Pension expenditure not covered by these tax changes could be reduced via the increase in Age Pension Age.

It is suggested that this approach of taxing investments has advantages over alternative approaches to funding the Universal Age Pension - such as having a specific Age Pension social security levy on salary and wages or taxing the Age Pension paid to middle and higher earners more heavily.

- It is much simpler to explain;

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[23] Service Pension, Service Pension partners, War Widows and Disability Pensions (not receiving a service pension). Note an approximation has been made for the age distribution of Disability Pensioners not receiving a Service Pension due to lack of data.

[24] from Treasury's 2007 tax expenditures statement

[25] Authors estimate based on pension assets of $300bn (Rice Warner Actuaries), an average current tax rate of 9.0% for accumulation assets and an average current tax rate of pension assets of -4.0% and an average before tax investment return of 8.0%)

[26] the 2007 IAAust paper "Tax-free superannuation benefits: a future revenue problem?" forecast that superannuation investment tax revenue was to triple as a % of GDP between 2007 and 2040

- Provides an incentive for continued workforce participation (zero marginal tax rates – compared with an approach of taxing the Age Pension which has employment disincentives);
- It improves integration of state funded and privately funded retirement benefits;
- It is administratively efficient;
- It is more progressive (taxing asset rich);
- It is better for transitional arrangements as many of the beneficiaries of the change will contribute tax revenue towards receiving the Age Pension. (A wage based levy would mean current rich retirees would not contribute to the cost of receiving their Age Pension); and .
- A wage based social security levy to fund both current and future Age Pensions would be very high (around 6% or 7% of pre tax wages).

Isn't This just Replacing One Tax with Another?

The assets and income tests can be thought of as a tax on private pension income. This proposal is essentially replacing the means test "tax" with other taxes – so what's the point?

Appendix F draws attention to the problems of the means tests. They are a highly inefficient and behaviour distorting tax. Replacing them with an administratively simpler tax would generate better economic outcomes in terms of economic growth (due to higher workforce participation and less distorted investment decisions) and equity.

"Better super" (originally called "Simpler Super") represented a tax cut on retirement income for the wealthy. This left the only tax on superannuation retirement income being the Age Pension means tests. This proposal restores fairness to the taxation of retirement income.

Removing the means tests would also improve adequacy for the large portion of people projected to receive a part Age Pension. It would also remove the concept of "double dipping", and would help people focus on making their superannuation last throughout retirement.

The removal of the assets and income tests would also mean that people would be able to better utilise their home in their retirement savings (as people are penalised by the assets and income test if they "down size" their home and invest the proceeds).

Many economists consider that capital gains are simply another form of investment income, and to treat them differently from other income has distorting effects (as well as inviting creation of avoidance mechanisms). It would be reasonable however, to allow for "averaging" of the marginal tax rate to be applied following sale, over the period the asset has been held.

Some notes on CGT are set out at the end of this Appendix.

Transition - Options

(a) *Remove means test for older people first*: say, remove means tests for all those over age 75 from 1 July 2010, gradually reduce age where means test ceases to apply over 10 year period. As shown above, this would have very little immediate impact as the percentages of retirees already reliant on income support over age 75 is very high – and would allow a long lead time to scrap the capital gains tax discounts.

(b) *Fixed Future Transition Date for all*: put tax measures in place now and remove means test for all people over Age Pension age from 1 July 2012

(c) *Blend* – during the transition period reduce impact of age pension means test by steadily increasing income and asset thresholds

Other issues

Rent Assistance

Issues that would need to be considered in implementing a Universal Age Pension is whether Rent Assistance should be given to the relatively wealthy that would become eligible for the Age Pension for the first time, and whether those who have a part Age Pension should receive the full amount of Rent Assistance.

One possible approach is to retain the means test for Rent Assistance. The amount paid could be reduced for those whose assets or income lie between the thresholds for a part (non Age) Pension, in a similar manner to that suggested in Appendix I.

Another approach may be to provide Rent Assistance on a non means tested basis. While around 30% of current Age Pensioners are not home owners, only around 11% claim Rent Assistance. Accordingly the cost should not be excessive

It may be argued that wealthy non home owners may unfairly benefit from this (eg, if they have an investment property). However, the following points can be made:

- Under this proposal, they will be paying higher taxes – full rate on CGT and 15% on investment income if this is in a super fund, including on pension assets (higher if not in super).
- People have emotional reasons for living in their own home; "gaming" the system to secure more Rent Assistance is unlikely a major incentive for selling.
- In any case, if a pensioner wants to sell a primary residence (which is exempt from tax) to claim Rent Assistance, they will be investing the money somewhere. They will then be paying tax on their investment income and capital gains in the future at the proposed revised rates. The larger the investment, the larger the tax paid (likely to be more than covering Rent Assistance).

Fringe Benefits

The "fringe benefits" (eg, Commonwealth Health Seniors Card) would be available to more people than is currently the case. This will have an extra cost. However it is not likely to be excessive as many self funded retirees get them now.

Notes on Capital gains Tax

The 1999 Ralph review put the following arguments in favour of *cutting* capital gains tax:

- It would encourage a greater level of investment, particularly in innovative, high growth companies (particularly Venture Capital);
- It would substantially improve the operation of Australian capital markets;

- It would help support a stronger investment culture amongst ordinary Australians;
- Other countries have more favourable tax regimes and competition for capital will become more intense. Failure to attract investment funds will mean lower levels of economic growth;
- A (then) recent Financial Review article argued that taxes on capital were "productivity sapping"

The following observations can be made:

- There is little evidence that there has been a substantially higher level of venture capital and growth investments following the introduction of the CGT discount in September 1999. The question has to be asked has the Government received "bang" for its tax expenditure "buck"? (could the cumulative $35bn in tax expenditures since 1999 have been better spent elsewhere?)
- The improvement in operation of capital markets is difficult to prove or disprove;
- Super funds have not changed their investment behaviour following the introduction of the discount;
- The main beneficiaries of reduced capital gains tax are wealthy individuals without changing behaviour
- The discount played a destructive role in accelerating a housing bubble (through the CGT discount applying to investment properties)

APPENDIX K

Purchase the (Balance of the) Full Age Pension

Introduction

Arguably, most people favour steady income in their working lives (in real terms) – or at least a significant part that is steady and meets needs. When “one off” expenditure is contemplated, this can be met from savings – or borrowing, following which adjustment is made to future disposable income to allow for repayments.

Arguably, this approach to managing personal finances would continue into retirement. Except, of course, “one off” expenditure can be met from lump sum superannuation. The problem is that managing a lump sum to provide a steady income and meet “one off” expenditure is rarely an attribute of retirees. And can be made more difficult when there are family and peer group pressures (supported by advertising directed at retirees) to meet a succession of “one off” expenditure “needs” and spend too much prematurely. Retirement can be as long as 30 years or more, with uncertainty as to lifestyle and health needs and desires over this period.

If it is accepted that, for most people, the ideal retirement income is one that is level in real terms and adequate throughout retirement, some measures need to be taken to wean Australians off the “lump sum” mentality and (re)introduce a culture of retirement *pensions.*

Government assistance in the form of issuing more long term indexed bonds, and longevity bonds (which broadly reinsure increasing longevity risks), would enable life companies to offer more attractive indexed lifetime annuity terms. But this may not be enough for voluntary purchase: investment would still be based on fixed interest assets where the returns often appear low, and some conservatism would continue to be needed in determining the terms.

The Government, having access to future taxation revenue, could offer more generous terms than life companies for the purchase of pensions which could still be fair as between generations of taxpayers.

Purchase of the Age Pension from the Government

As a start to developing a retirement *pensions* culture, self funded retirees could be given the opportunity of purchasing from the Government a pension equal to the Age Pension – or the balance up to the full amount for those currently entitled to a part Age Pension under the Means Tests.

Government Incentive

Currently, around 70% of those reaching age 65 claim a part or full Age Pension. This compares with around 85% for those now age 85. To some extent this reflects the greater saving by the more recently retired. But increasing reliance on the Age Pension with advancing age tends also to occur as a result of the other income of many retirees not keeping pace with inflation, or assets being spent.

The Intergenerational Report update issued in 2007 commented that “the proportion of the eligible age group not receiving any Age Pension is projected to rise *[only]* slightly” [our emphasis]. With rising superannuation benefits expected to result in some fall in those claiming the Age Pension immediately on reaching the eligible age, this comment implies that the increasing incidence of claiming with advancing age is expected to continue.

Encouraging self funded retirees to use part of their assets to purchase the Age Pension would reduce the potential problems of many at later ages, and make them simpler for the Government to manage.

Objectives of the Proposal

(1) To enable self funded retirees to purchase an indexed lifetime pension with part of their wealth on an attractive basis.

This represents a desire to satisfy a general need in the face of apparently unattractive products available from life companies.

This is clearly a useful objective. Purchase of the Age Pension as a lifetime annuity should satisfy this objective. It should also be capable of easy implementation – either by the Government providing the purchased pension directly, or providing reinsurance for life offices willing to participate in such provision in the form of an annuity.

Purchase of the Age Pension in these circumstances would be an “investment”. As such, if some or all of the retiree’s remaining investments were consumed over time, the retiree could ultimately become eligible for a “Social Security” part Age Pension as well! This outcome could be considered as less than optimum.

Pursuit of two further objectives could therefore be considered in order to assist meeting the needs of the Government and individuals in a climate of increasing longevity.

(2) To limit the Government’s potential financial burden when increasing numbers of self funded retirees with increasing longevity exhaust their investments.

This objective may be satisfied by making the purchase the securing of a full “Social Security Age Pension, rather than simply an investment in an annuity. In the case of existing part Age Pensioners, the purchase of the “balance” would result in their becoming full “Social Security” Age Pensioners.

(3) To give self funded retirees the opportunity to ensure that, throughout their lives, they will never need to apply for a means tested Age Pension.

The inclusion of the third objective satisfies the likely further desire of both the Government and many retirees – to avoid the messy processes and embarrassments to be endured in means testing.

Selling a “Social Security” Age Pension (or balance of the full Pension for part Age Pensioners) on this basis also has the advantage for the Government in utilising the same ongoing administrative procedures as those required for paying the pension to those currently eligible as a result of need – but without the means tests.

Cost - Investment

The following numbers compare:

(1) estimates of the current market cost of purchasing annuities from a life company equal to the Age Pension, assuming 4% pa future increases, with

(2) possible purchase prices which might be acceptable to the Government for future payment of the Age Pension (ignoring the Health Card and other "fringe" benefits).

	Annuity / Pension Purchased	(1) Annuity Market Price	(2) Pension – possible Government price
Male 65	*$14,368 pa*	**$289,000**	***$240,000***
Female 63	*$14,368 pa*	**$344,000**	***$277,000***
Couple: male 65 female 63 (reducing to 60% on the first death)	*$23,904 pa*	**$550,000**	***$462,000***

Life companies must adopt conservative assumptions as regards future investment returns. The Government could take the view that a reasonable investment return to be assumed was more in line with that targeted for the Future Fund – ie, inflation, say 2.5%, + 5% = 7.5% pa, rather than a long term bond return of around 6% pa necessary to be assumed by life companies. The above Government numbers assume this, together with 4% pa expected increases, 5% of pension payments for expenses, ALT 2000-02 mortality less 5 years for selection, and improving longevity.

Adoption of a basis involving a future long term investment return assumption would have the advantage of requiring relatively infrequent changing of purchase price rates.

Social Security Aspects – Fringe Benefits

Eligibility for the Age Pension brings with it the availability of Pensioners Concession Card benefits.

It would be reasonable for buyers of the Age Pension to also receive these "fringe benefits". This would fit well with the objectives of the initiative, and simplify administration.

Of course, those eligible for a part Pension and considering buying the "balance" will already be receiving the "fringe benefits". Moreover, self funded retirees whose annual taxable incomes are less than $50,000 ($80,000 for a couple) can also receive some of these benefits via the Commonwealth Seniors Health Card. Consequently the additional outlay in respect of fringe benefits by the Government where retirees purchase the Age Pension, is likely to be relatively small.

Against this cost, are the savings the Government will reasonably expect to make as a result of treating the purchased Age Pension as "Social Security" rather than as an investment of the purchaser, and avoiding the potential payment of a future "second" Age Pension if the pensioner's other investments are consumed or otherwise fall in value.

Examples

The following examples provide some indication of possible utilisation of an option to purchase the Age Pension (including pension supplement, paid since 2000 following introduction of the GST, and pharmaceutical allowance). The purchase price is assumed to be determined on the same basis as adopted above. For simplicity, it is assumed that there is no employment income, and, in conducting the Means Tests, the assets test is the most stringent in each case. All assets are superannuation, and the account based pension drawdown assumed is 6% pa for single lives and 5% for couples. All numbers are in $'s, and pensions are pa.

Single Male Age 65

Total Assets	Eligible Age Pension or Part Pension	Pension to be Purchased	Cost of Pension Purchased	Balance of Assets	Income	
					Before Purchase	After Purchase
600,000	Nil	14,368	240,000	360,000	36,000	*35,968*
450,000	3,507	10,862	181,000	269,000	30,507	*30,508*
300,000	9,357	5,012	84,000	216,000	27,357	*27,328*
150,000	14,368	Nil	Nil	150,000	23,368	*23,368*

Single Female Age 63

Total Assets	Eligible Age Pension or Part Pension	Pension to be Purchased	Cost of Pension Purchased	Balance of Assets	Income	
					Before Purchase	After Purchase
300,000	9,357	5,012	96,000	204,000	27,357	*26,608*

Couple: Male 65, Female 63

Total Assets	Eligible Age Pension or Part Pension	Pension to be Purchased	Cost of Pension Purchased	Balance of Assets	Income	
					Before Purchase	After Purchase
600,000	10,001	13,904	270,000	330,000	46,001	*43,704*

Comment

Of course, incomes in future years should be compared as well as those suggested for the first year. However the income drawn from the superannuation assets is likely to fluctuate and may not last throughout life. Importantly, the Age Pension component of the incomes shown is guaranteed for life and will increase with inflation.

Capital Protection

The Age Pension represents a lifetime annuity without any guaranteed payment period or benefit on early death.

Many purchasers of such an annuity would be concerned over "their" "loss of capital" on early death. It is suggested therefore that purchasers of the Age Pension be given the option of including "capital protection", ie, in the event of death, the excess of the purchase price over pension payments received be payable to the purchaser's estate.

It is estimated that for a male age 65, this should increase the cost by only about 7%, and less for females and couples.

Taxation

A pension purchased within a superannuation fund would be exempt from tax.

Accordingly, a purchased Age Pension would also need to be tax free. However, this would add some complexity to the proposal. For those with a part Age Pension, they would have that part taxable under current legislation and the purchased balance tax free.

It is noted though, that little tax is actually paid on Age Pensions – perhaps a total of around $0.5b in the current year. Consideration could be given to making Age Pensions exempt from tax. This would achieve consistency with the treatment of private superannuation pensions, as well allowing payment of a full Age Pension made up of an eligible part and a purchased balance, to be wholly tax free.

Employment Earnings

A resumption of paid employment after receiving a part Age Pension, or any change to employment earnings, would generate a revised Means Test assessment resulting in a change in the part Pension being received – or being stopped altogether.

Clearly, the simplicity of the proposal to allow purchase of the balance of the Age Pension, permitting the whole pension to be paid without further Means Tests cannot operate in such circumstances.

It would be necessary to exclude earnings from personal exertion from the Means Test when applying to purchase the balance of the Age Pension. This might be considered a good incentive to encourage such purchases!

It could be argued though, that eliminating employment earnings from the Means Tests for *all* Age Pensions would be a good policy generally. An estimate of the cost of this to the Government for the current year is around *$1 billion. (refer to Appendix G)* This compares with the Budget estimate for total Age Pensions currently, of *$24 billion*.

In practice, this measure would create an incentive to continue/resume working. The economic benefit from the likely increase in the work force participation rate could easily offset the relatively small cost of not assessing employment earnings for those in excess of Age Pension age.

For retirees already working in the “black economy” and “coming out of the woodwork” and disclosing their earnings, there would be no cost to Government from this measure!

Conclusion

Implementation of the proposal to allow self funded retirees to purchase the Age Pension could reduce significantly the number of retirees becoming Social Security Age Pensioners later in life. A variant of the proposal could also eliminate on going Means Tests and related administration for part Age Pensioners purchasing the balance of the Age Pension, as well as securing indexed lifetime income for them.

The proposal represents a reasonable option for a government, concerned about the financial consequences of the ageing population and keen to see more retirees effecting indexed lifetime pensions, but which does not wish to provide direct assistance to the life insurance and superannuation industries to encourage such pensions on a private basis.

Introduction of the proposal on an optimum basis may however require:

(1) the exclusion of future employment earnings from the Means Test – either for the purchasers, or all part Age Pensioners;

(2) the scrapping of future means testing for both any existing part pension and the purchased pension; and

(3) the Age Pension to be made tax free.

Arguably though, such changes may well be considered to be worthwhile on their own merits, apart from simply improving the proposal to allow purchase of the Age Pension.

Postscript

Allowing purchase of the Age Pension would need to be supported by strong education initiatives to obtain widespread knowledge of the option.

At the same time, it would be desirable to see development of a “culture” to buy private lifetime annuities with part of superannuation proceeds. In this regard, as suggested at the beginning of this Appendix, the Government could assist this development by issuing longer term indexed bonds, and longevity bonds.

It would also be desirable to ensure that all future retirees are made aware of the opportunity to purchase lifetime annuities privately and/or the Age Pension from the Government. Super fund PDS’s could be required to include reference to such retirement options. Applications for account based pensions or other withdrawals from the fund could include a section for acknowledging awareness of such options.

Undoubtedly, purchasers will tend to be those anticipating a long retirement – ie those in good health. However, if such purchases became widespread and part of retirement “culture”, it may become politically acceptable to make them the best option for most future retirees who wish to claim a part Age Pension.

Indeed, purchase of the balance of the Age Pension could be made a *condition* of the availability of a part Age Pension.

The alternative could simply be using up their own funds and then claiming the full Age Pension. This could be preferred by those in poor health.

Existing part Age Pensioners could be given the option of purchase of the balance, but would be able to remain on the current system of means testing if they wished.

Eventually though, means testing for Age Pensions after the initial assessment could cease to exist for *all* retirees.

Then, effectively, we would have a Universal Age Pension – but only for those who need it or want it.

APPENDIX L

A Single "Unable to Work" Pension - Towards Abolishing Retirement

This option is explored in more detail in Darren Wickham's 2007 paper "It's time to abolish retirement (and here's how to do it)".

Increasing lifespans and improving health at older ages mean that a fixed age social security retirement benefit does not make sense. As an ever increasing portion of over 65s are healthy and capable of work, it means (by default) a shift is occurring in the philosophy underpinning the Age Pension:

- moving away from targeting need (old age poverty arising as a result of disability or unemployment),
- to subsidising leisure (for over 65s who are healthy and capable of work).

As suggested in the abovementioned paper – disability and unemployment are arguably more suitable triggers than a fixed eligibility age for the receipt of benefits.

Proposal:

- The Age Pension, Disability Support Pension and Newstart (unemployment) Allowance are merged into a single "Unable to Work" pension.
- There is a single payment level for all recipients.
- Means tests could either be
  - Abolished (ie universal pension); or
  - Retained (but made the same for all categories of benefit).
- There is no "eligibility age" for a retirement benefit.
- There would be a long transition period (via a steadily increasing Age Pension eligibility age).

Advantages of proposal

- Fundamental shift in how society perceives old age;
- Increase in workforce participation;
- Social benefits for older people remaining in workforce;
- Improved work/life balance throughout entire life; and
- Transformation of superannuation into a lifetime savings vehicle instead of just for retirement. Assists transitions in workforce to and from learning, unemployment and disability.