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Super Policy Forum

What policy options should be considered to improve adequacy?

Actuaries' views



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Retirement income objectives

Andrew Boal

*Retirement income policy should **encourage** people to achieve a higher standard of living **in retirement** than would be possible from the **age pension alone**, while ensuring that all Australians have **security** and **dignity** in retirement* (Treasury 2006)

The 3 pillars

- *Age pension – means tested*
- *Employer super – SG level needs to be balanced between future retirement objectives and current living standards*
- *Voluntary savings – to meet personal retirement goals, such as early retirement or higher income level*
- *But what “encouragement” to provide?*

Retirement age

ABS study in 2004-05 of retirement age

	Male	Female	Total
Current Retirees	58	47	52
Previous 5 years	62	58	60
Survey Age 45+	63	61	62

Source: Australian Bureau of Statistics (ABS)

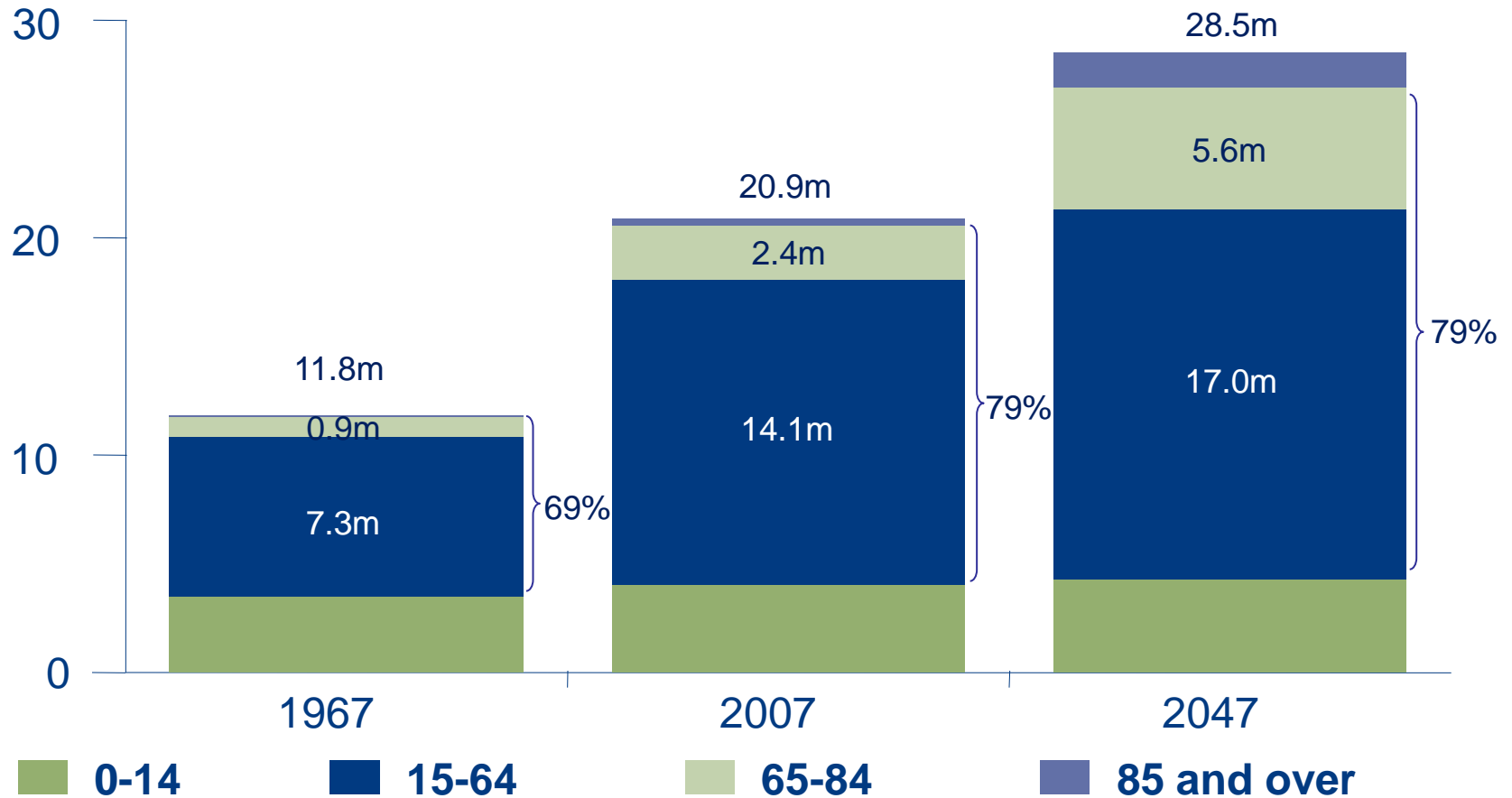
Retirement age

- **10% in survey never intend to retire**
- **45% did not know**
- **Of the rest, 48% indicated age 65+**
- **Influencing factors were health (40%), financial security (36%) and eligibility for the age pension (15%)**
- **Manufacturing was 32% of the economy in the 1960's, only 12.2% in 2005 and projected to be 7% by 2015**
- **Older Australians need to remain active**

Retirement age

Australian Population

Millions



Source: ABS and Treasury Projections

Dignity

Retirement Living Standards

	Single person (% of AWOTE)	Couple (% of AWOTE)
Age Pension	25%	42%
Henderson Poverty Line	26%	37%
Modest (Westpac/ASFA)	35%	50%
Comfortable (Westpac/ASFA)	69%	92%

Source: ASFA (2004 report) and ABS

Dignity

Replacement Income in Retirement Based on the SG at 9%

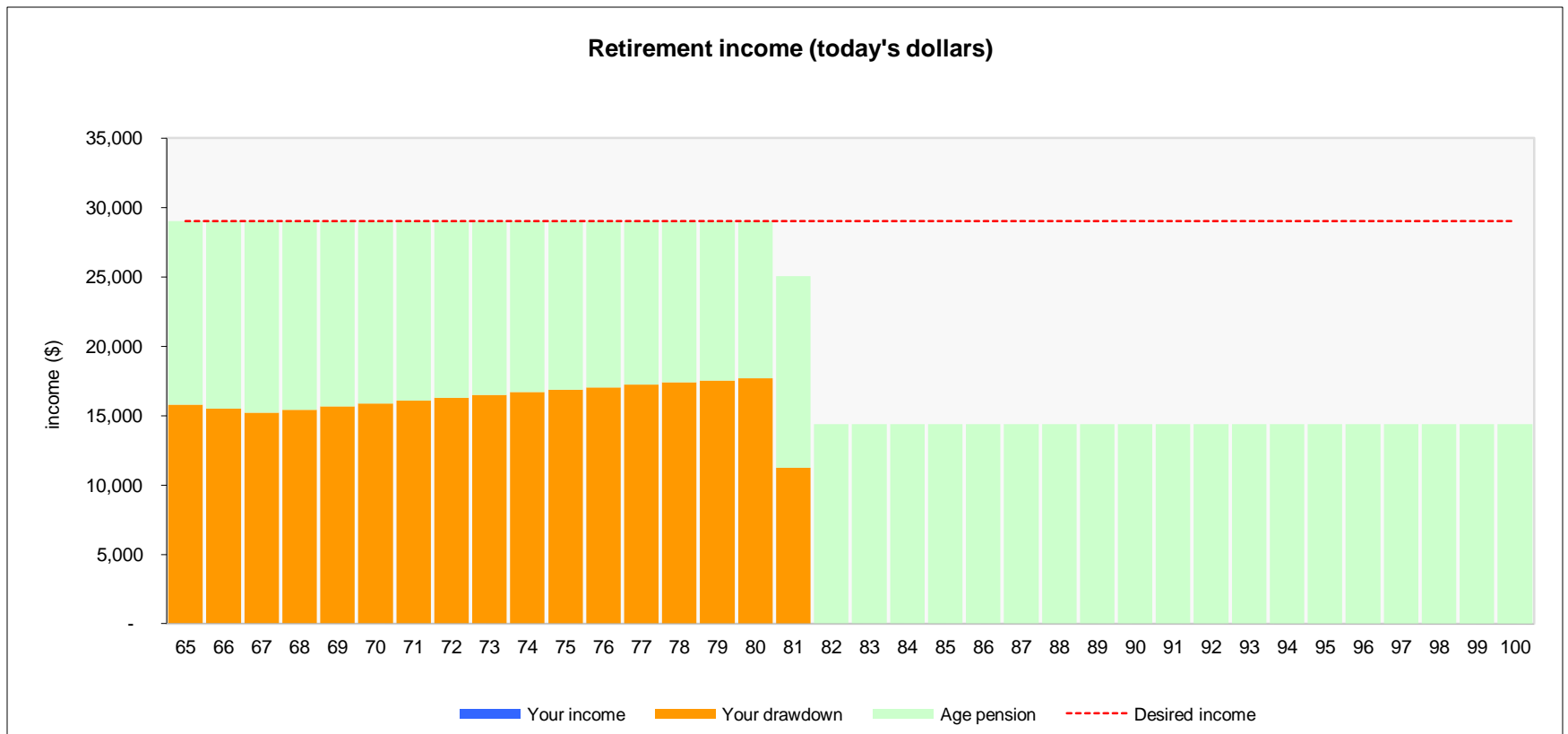
Retirement Age	% of Pre-Retirement Income (after-tax)	
	Scenario 1 Low income, single	Scenario 2 Middle income, couple
65	103% (51.5% of AWOTE)	60% (120% of AWOTE)
70	121%	76%
75	150%	107%

Source: Watson Wyatt research and analysis

Note: Effective tax rate on AWOTE is about 20%
Most employees (about 70%) earn less than AWOTE
Median earnings of that group is about 75% of AWOTE

Security

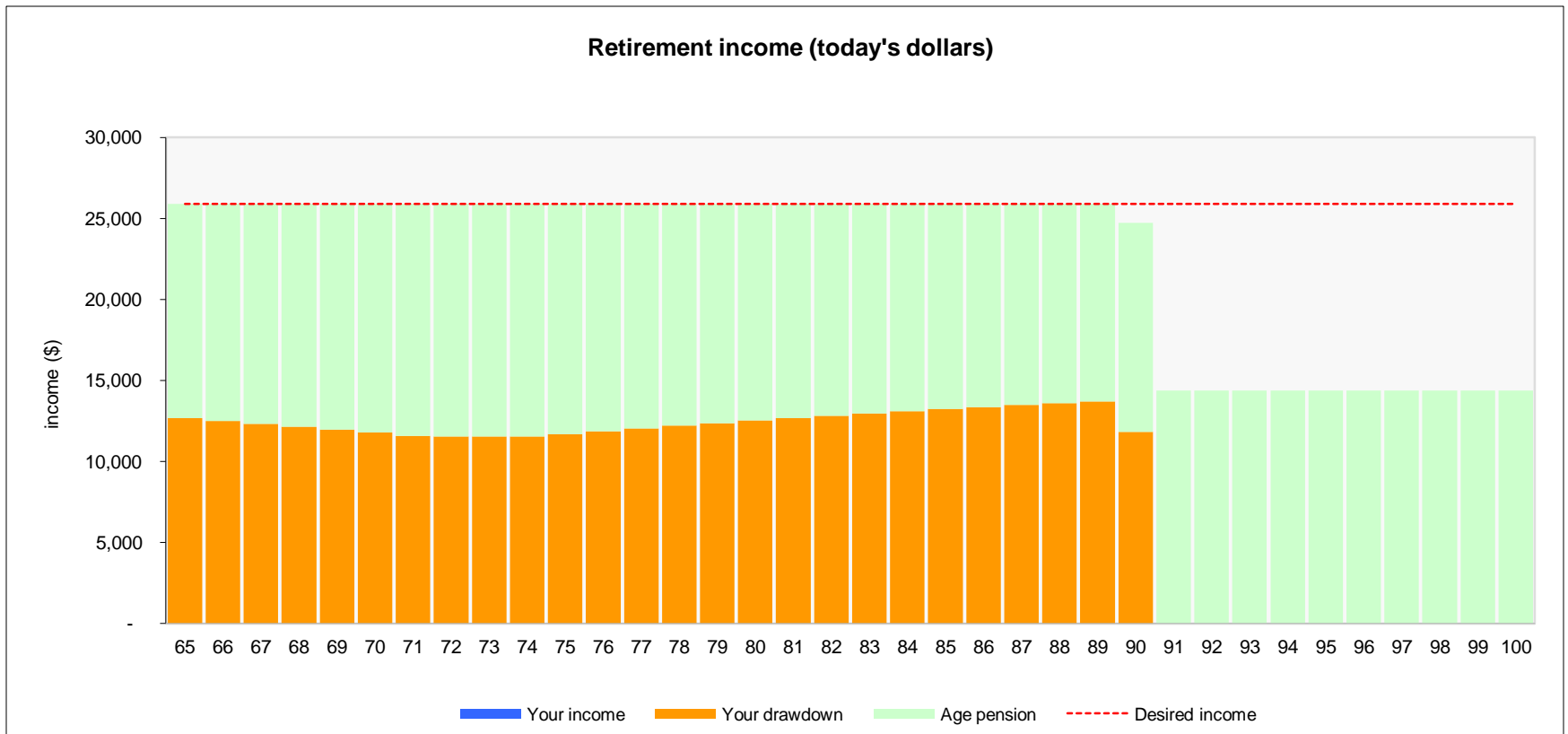
Scenario 1: Low income (50% AWOTE), single



Source: ASIC Retirement Planner

Security

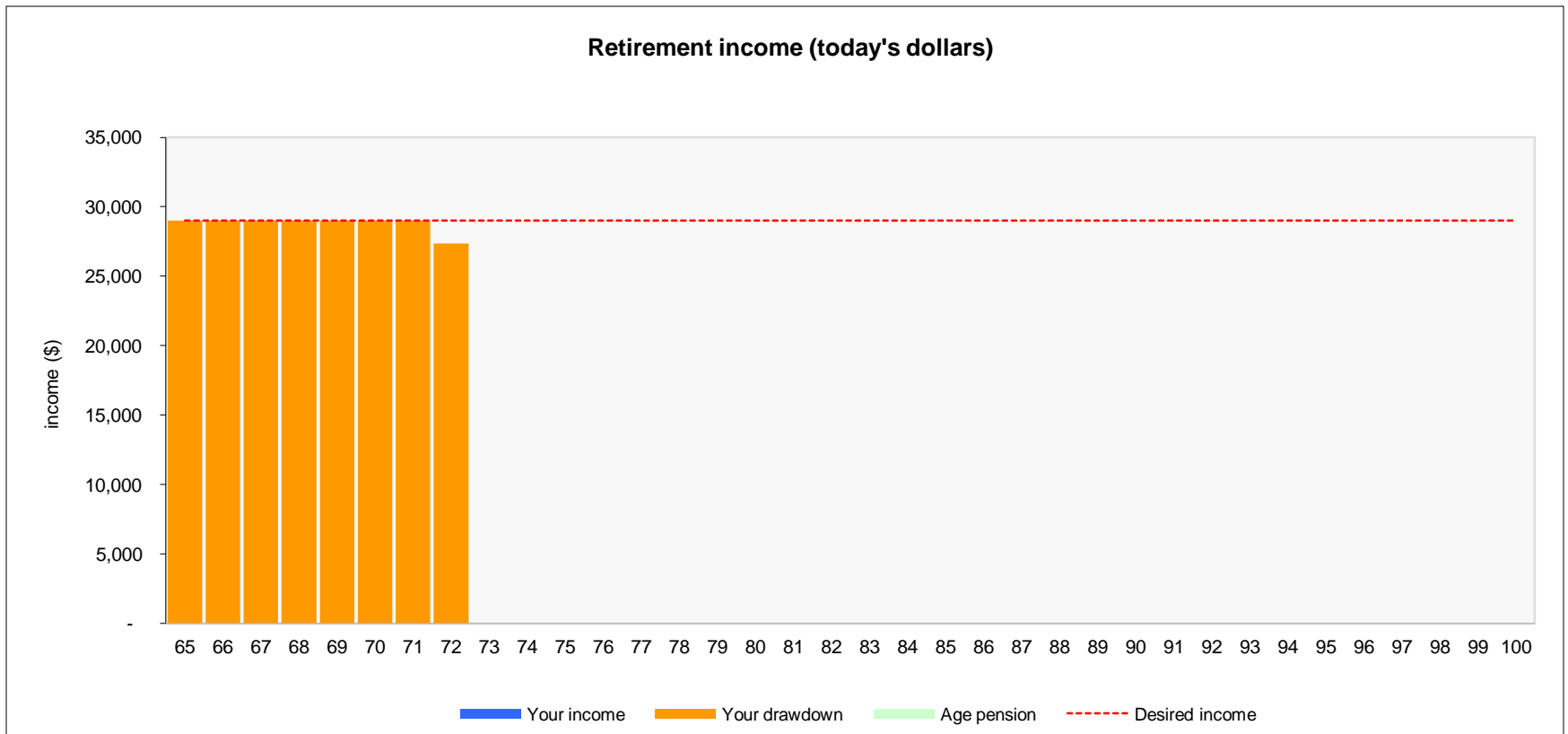
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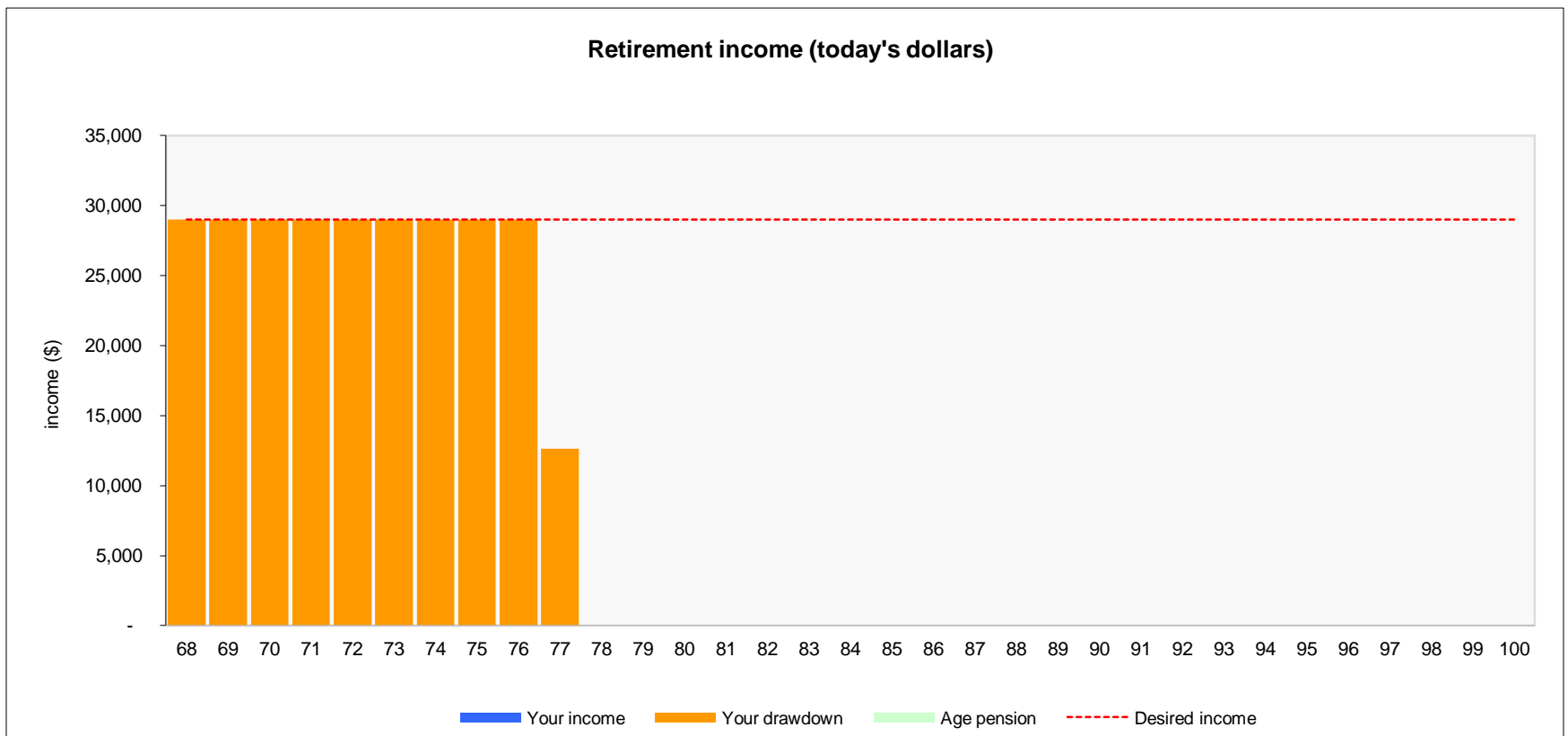
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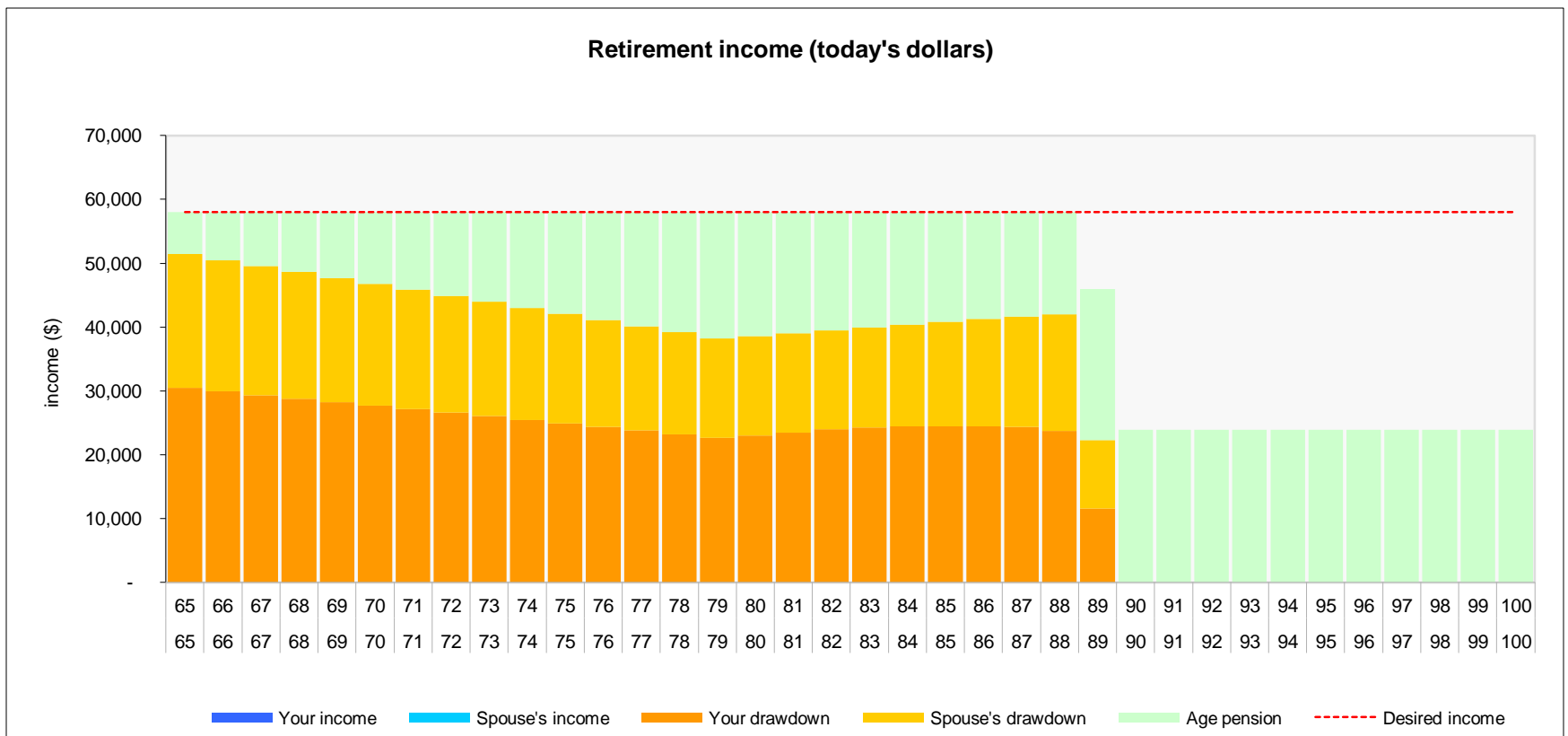
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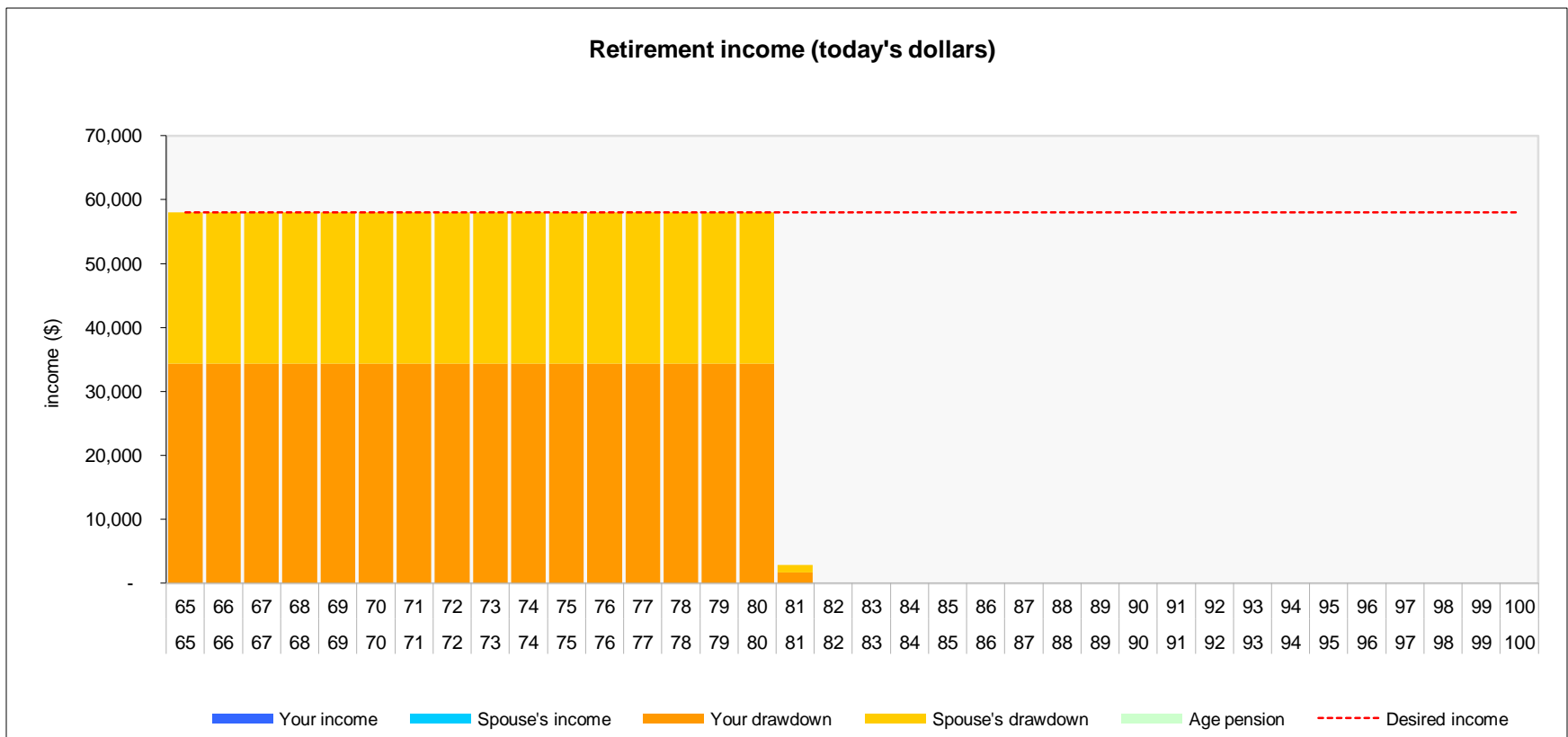
Scenario 2: Middle income (both AWOTE), couple, 10 year gap



Source: ASIC Retirement Planner

Security

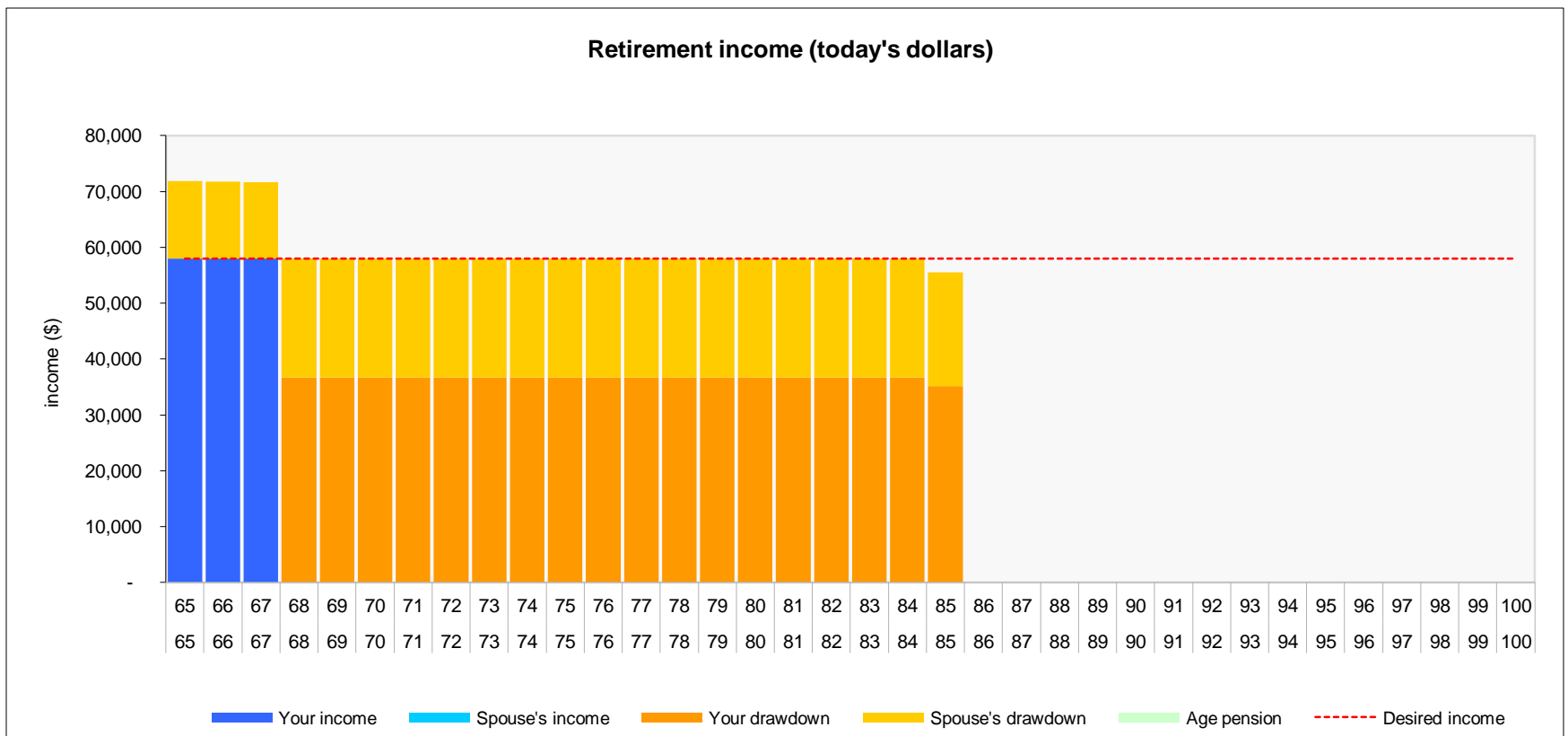
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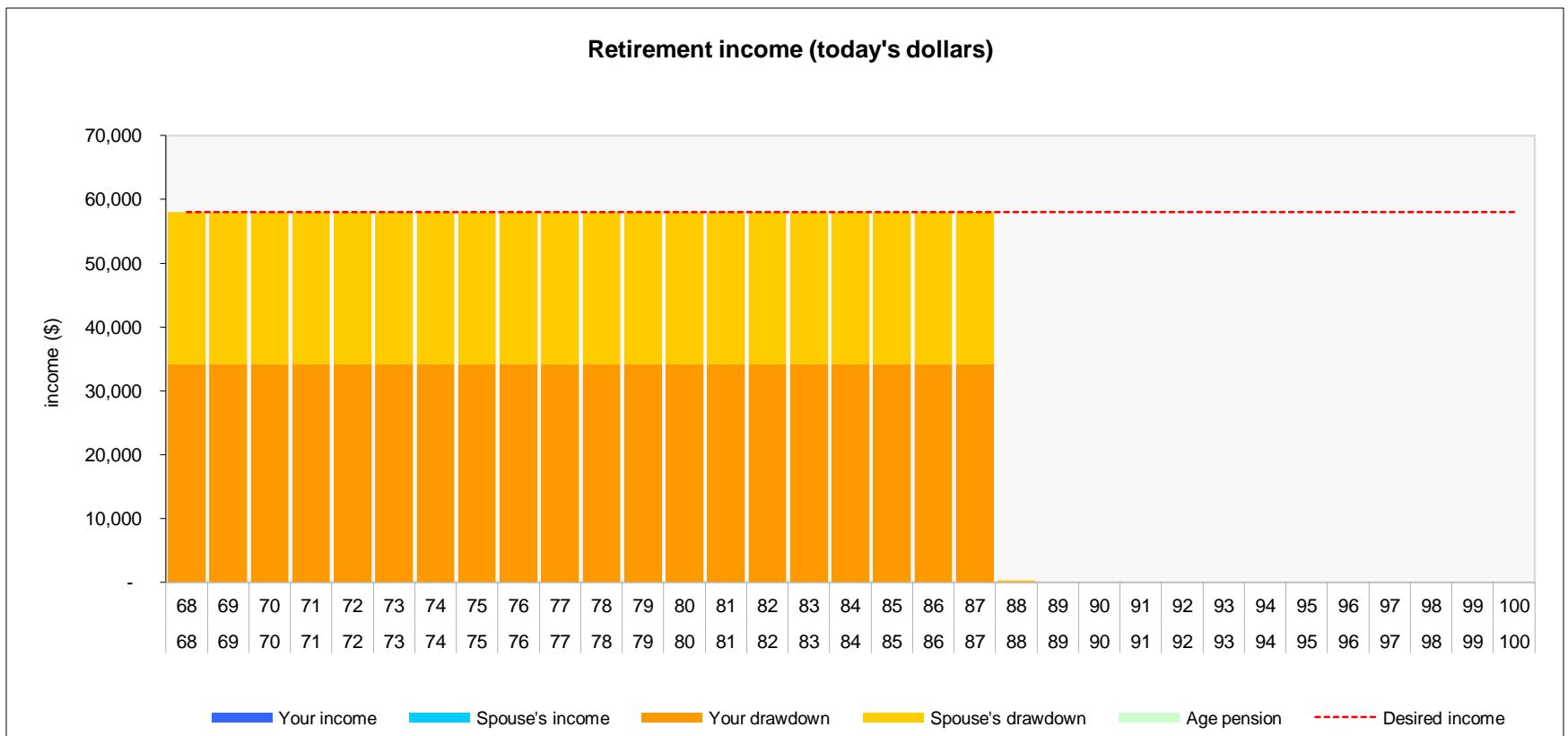
Scenario 2: Middle income (both AWOTE), couple, 10 year gap



Source: ASIC Retirement Planner

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Scenario 2: Middle income (both AWOTE), couple, 10 year gap



Source: ASIC Retirement Planner

Security

- **The SG system is not yet mature – what “encouragement” (co-contributions etc) should we provide for mid-career savers and others in the long term?**
- **Longevity risk is very difficult for individuals to manage and the conservative use of the savings is not efficient – how can the government (age pension) and/or capital markets (post-retirement products) help?**



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Deferred Age Pension

Simpler Means Test

Cathy Nance

Current issues

- **80% of “over 65s” are on all/part Age Pension**
- **Need to encourage**
 - work \geq 65
 - Reduced reliance on Age Pension
- **Currently very high implicit taxes on work \geq 65**
- **Growing pressures**
 - on “65” for Age Pension
 - on \$14,400 for single Age Pension

Income p.a.	Modest	Comfortable	Age Pension @June 2008	Age Pension as %age of 'Modest'
Single	18,654	36,141	14,368	77%
Couple	26,154	48,374	23,904	91%

Option for Deferred Age Pension

- **Can elect to defer Age Pension “entitlement”**
 - Entitlement is based on Means Test
- **Deferred Age Pension increases 5%-8% pa**
- **Example**
 - \$14,400 pa at age 65
 - \$20,000 pa at age 70
 - \$28,000 pa at age 75
- **No limit on deferral period**
- **Replaces Pension bonus scheme**
 - Lump Sum option up to Pension Bonus

Option for Deferred Age Pension

- **Advantages for Government**
 - No increase in cost
 - Reduced costs due to
 - Mortality
 - Taxes, whilst people remain in work
 - Reduced pressure on level of Age Pension
 - Voluntary option to increase Pension Age
- **Advantages for Individual**
 - Ability to plan resources for “known” time
 - Increased Age Pension at later date



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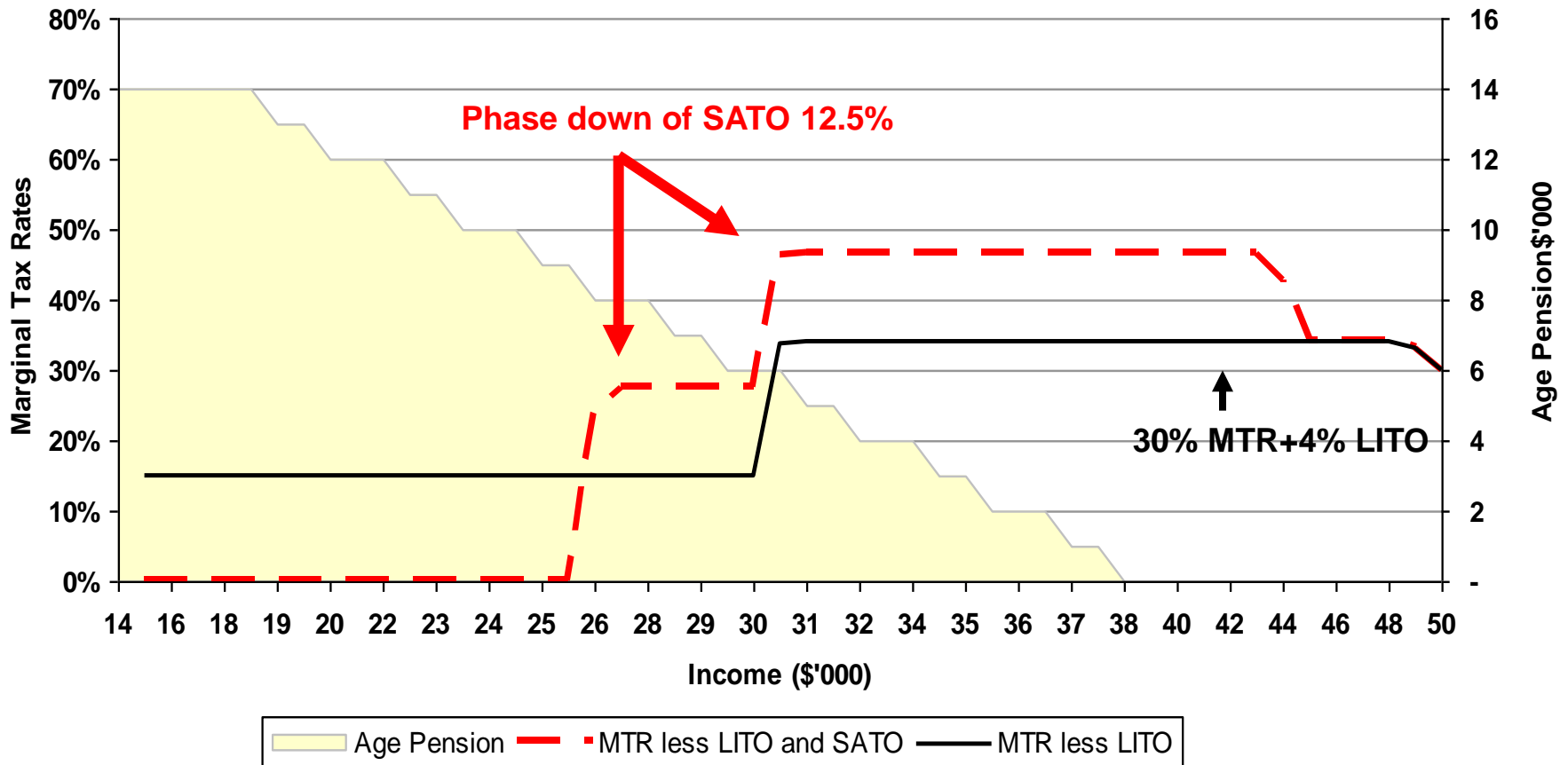
Deferred Age Pension

Simpler Means Test

Cathy Nance

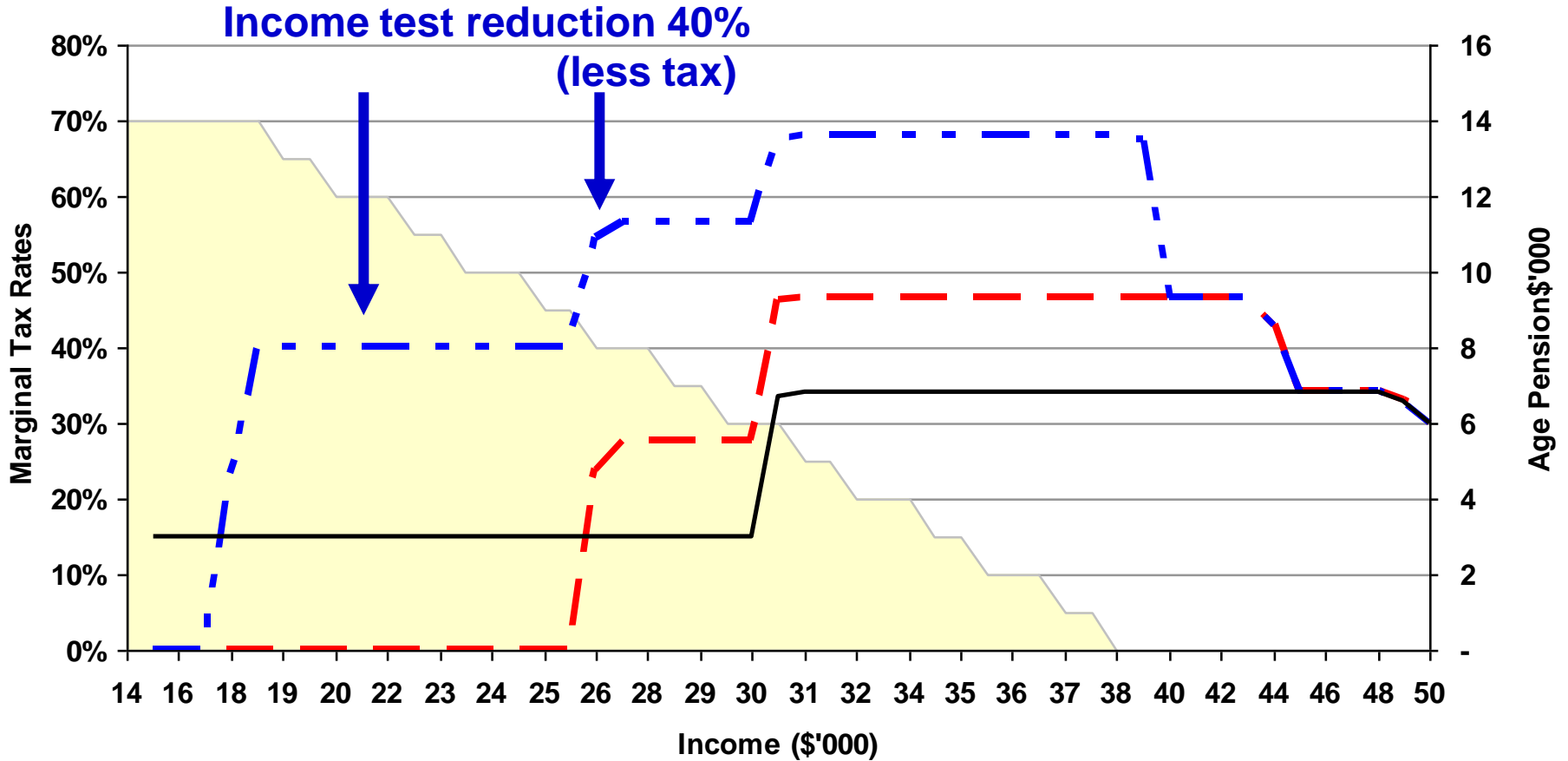
Marginal tax rates with LITO and SATO

Marginal Tax Rates



Marginal tax rates with Income Test

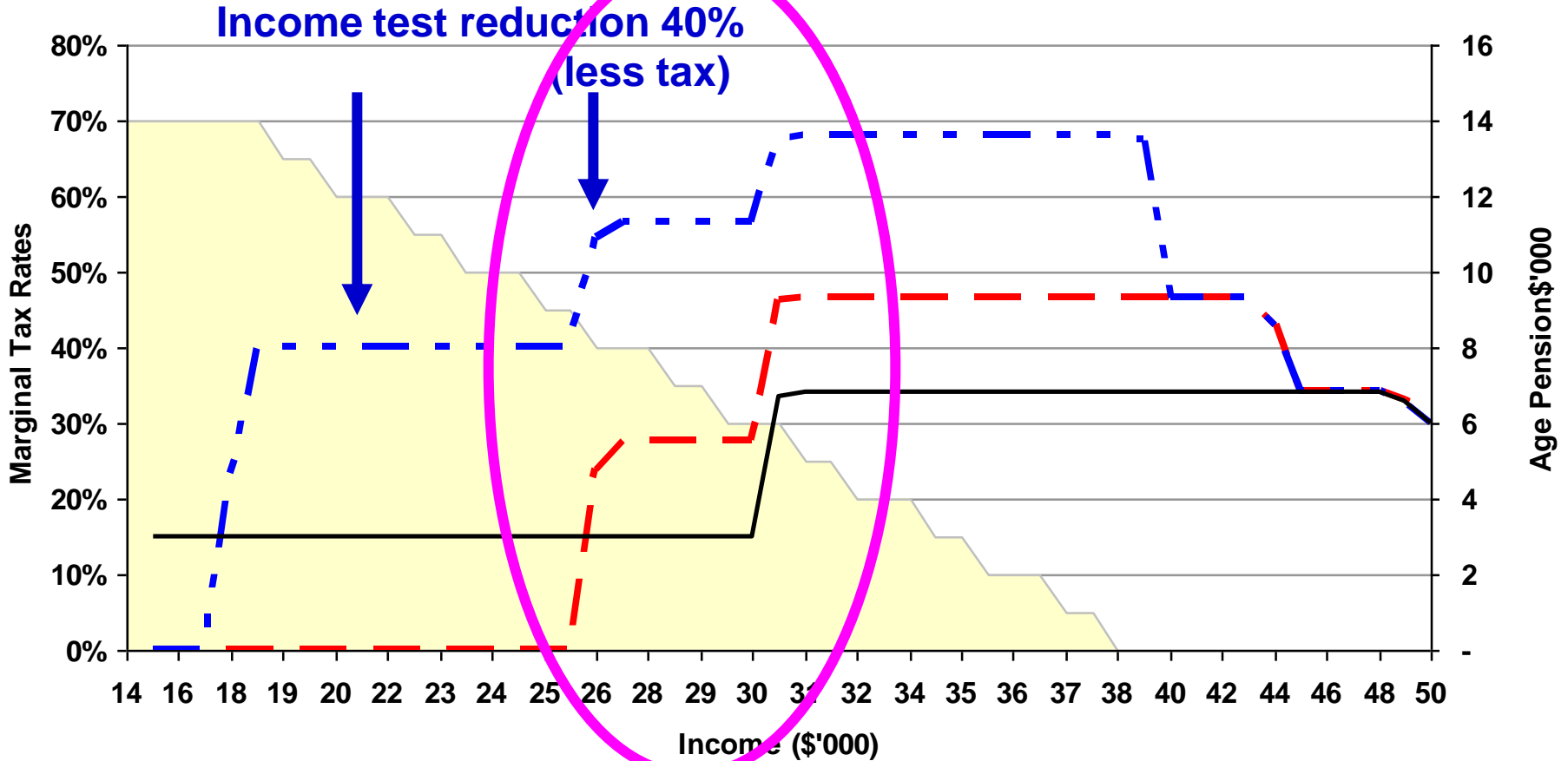
Marginal Tax Rates



Age Pension MTR less LITO and SATO MTR less LITO, SATO and AP reduction MTR less LITO

Marginal tax rates with Income Test

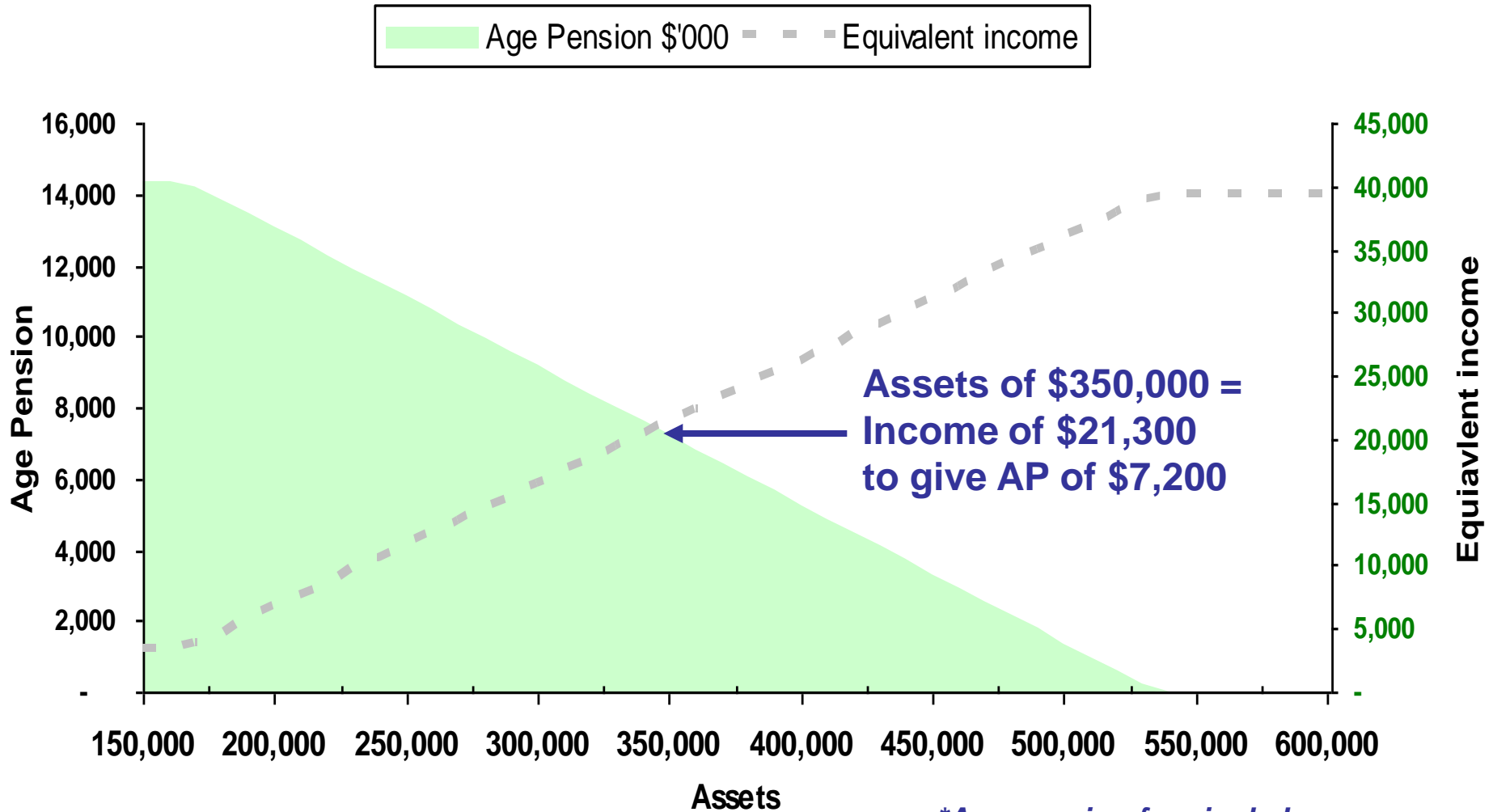
Marginal Tax Rates



Problems with Income Test

- **Major deterrent to work over age 65**
 - Very high marginal tax rates (up to 70%)
 - Not affordable to work!
- **Major administration burden!**

Asset Test vs Income test



**Assets of \$350,000 =
Income of \$21,300
to give AP of \$7,200**

**Age pension for single homeowner
Income = earned plus deemed

Option to remove Income Test

- **Asset test sets “maximum entitlement”**
- **Individual chooses between:**
 - Taking Age Pension, SATO does not apply
 - Deferring Age Pension, SATO remains
- **Could encourage or force deferral above a certain income level eg**
 - Impose x% (eg 20%) surcharge tax
 - Apply cap over which 50%-100% AP is deferred

Example Low Income

	Current rules	Current rules Plus 10k	New rules Plus 10k
Income	4.0	14.0	14.0
Max Age Pension	14.4	14.4	14.4
	18.4	28.4	28.4
Age Pension IT reduction	-0.2	-4.2	0.0
Tax (less LITO)	-1.1	-2.0	-2.6
SATO offset	1.1	2.0	0.0
Net Income (excl super)	18.1	24.1	25.8
<i>Marginal Tax Rate</i>		40%	15%
Government costs			
Age Pension paid	14.1		14.4
Tax recouped	0.0		-2.6
Net cost to Government	14		12

- **Assets of \$50,000 - \$150,000 (below Asset Test threshold)**
- **Current arrangements**
 - 40% MTR on any income over \$3,400 – so, why work!
- **New arrangements**
 - 15% MTR
 - Government still better off by \$2k pa compared to now!

**Age pension for single homeowner*

Example Mid Income

	Current rules	Current rules Plus 10k	New rules Plus 10k	New rules Deferral
Income	25.0	35.0	35.0	35.0
Max Age Pension	7.2	7.2	7.2	
	32.2	42.2	42.2	35.0
Age Pension IT reduction	-1.5	-5.5	0.0	
Tax (less LITO)	-3.1	-5.1	-7.0	-4.5
SATO offset	1.6	0.9	0.0	1.1
Net Income (excl super)	29.3	32.5	35.2	31.5
<i>Marginal Tax Rate</i>		68%	34%	35%
Government costs				
Age Pension paid	5.7		7.2	0.0
Tax recouped	-1.5		-7.0	-3.5
Net cost to Government	4.3		0.2	-3.5
<i>Plus deferral</i>				7.2

- **Assets of \$350,000**
- **Current arrangements**
 - 56%-68% MTR on any income over \$21,300 – so, why work!
- **New arrangements**
 - 35% MTR
 - Government better off by \$4k pa if Age Pension taken, or \$7k immediately, if deferred

**Age pension for single homeowner*

Key messages

- **Asset test determines Age Pension**
 - Take now, or defer and get increased AP later
 - Can defer all or part of AP in any year
 - Other AP entitlements remain
- **Remaining in work is now affordable**
 - Comparable tax rates to others in community
- **SATO 12.5% tax offset**
 - Applies to self funded retirees or deferred AP
 - If keep AP, pay comparable taxes to non-seniors

Benefits

- **Individual can plan for known period of time**
 - Use assets and/or income first, then deferred AP
- **Government**
 - **Asset test much easier to administer**
 - Annual requirement only
 - **Expected to reduce AP costs, not increase**
 - Increased tax revenues now
 - Immediate savings from AP deferrals
- **Risks**
 - **Increased incentive to hide assets outside super?**



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Post-retirement products

Steve Schubert

Retirees need to turn lump sums into income

- **Average retirement balances will grow as the super guarantee matures**
 - Typical age 65 benefit after 40 years could be over \$400,000¹
- **Retirees need to manage how they draw this down allowing for:**
 - Investment risk
 - Inflation
 - Life expectancy

Longevity is a significant risk for most retirees

Age	Men Alive	Women Alive	One or both alive
65	100	100	100
85	55	69	86
90	36	51	68
95	20	31	44
100	9	15	22

Source: Calculated from ALT 2000-2002 mortality tables.

Existing Product Range

- **Account-based pensions**
 - Leave all risks with retirees
- **Fixed term annuities**
 - Leave longevity risk with retirees
- **Lifetime annuities**
 - Unpopular with retirees and providers
- **Pooled risk pensions**
 - Slow to take off in Australia

Market-based solutions

- **More market-based products are possible:**
 - Annuities which pass investment risk/reward to retirees
 - Range of guarantees that can be selected and paid for by the retiree
- **But will require new market developments:**
 - Longevity bonds/mortality swaps
 - Longer term inflation hedges

Role of Government?

- **Should Commonwealth take on more risk?**
 - Already underwrites some longevity and inflation risk through the Age Pension
 - Issue longevity bonds or act as reinsurer?
 - Allow self-funded retirees to purchase Age Pension?
 - Issue long-dated inflation-linked bonds?
- **Ensure there are no unreasonable barriers to product innovation**
 - APRA, ATO, ASIC all need to be involved



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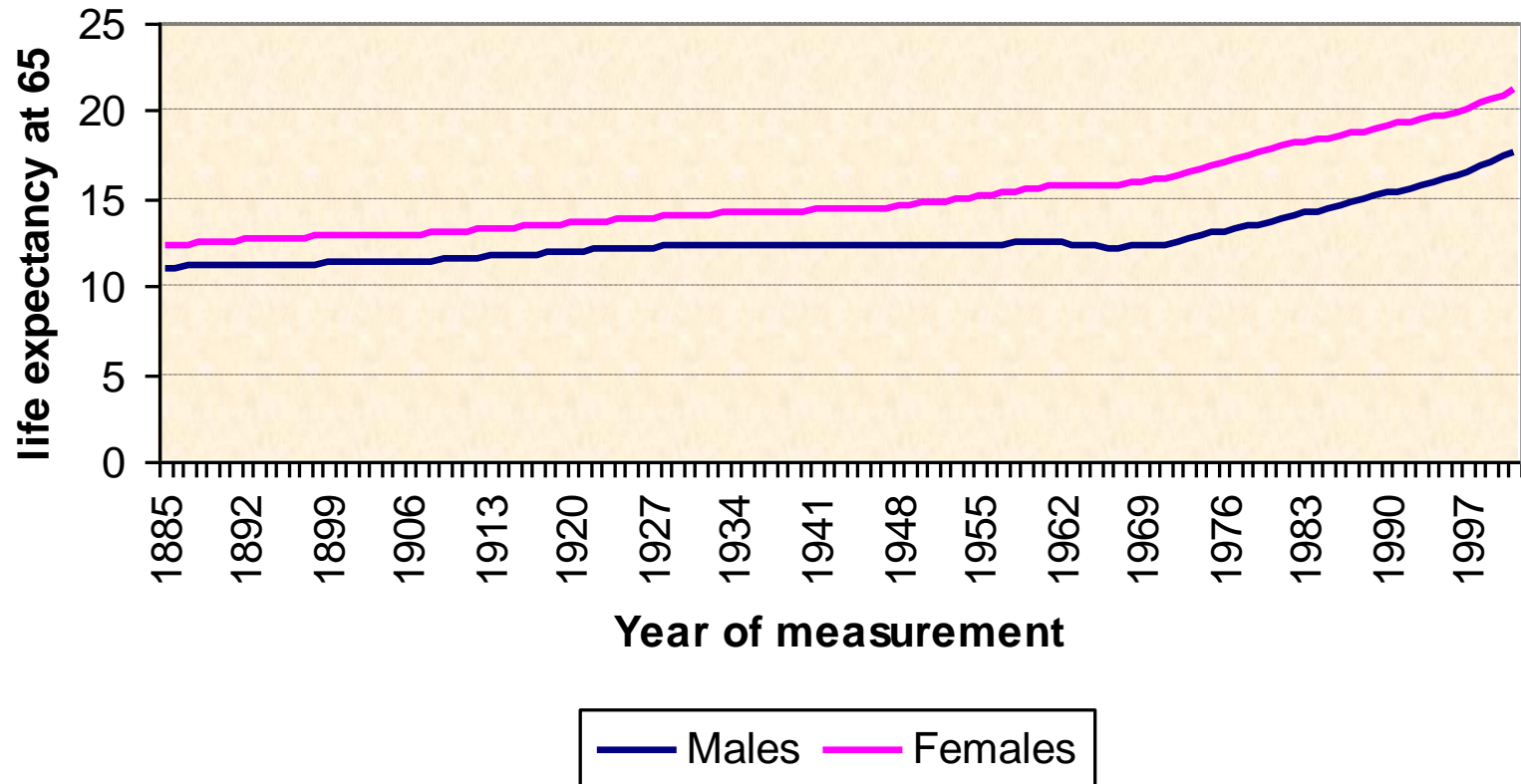
The pension age The role of compulsion – soft or hard?

David Knox

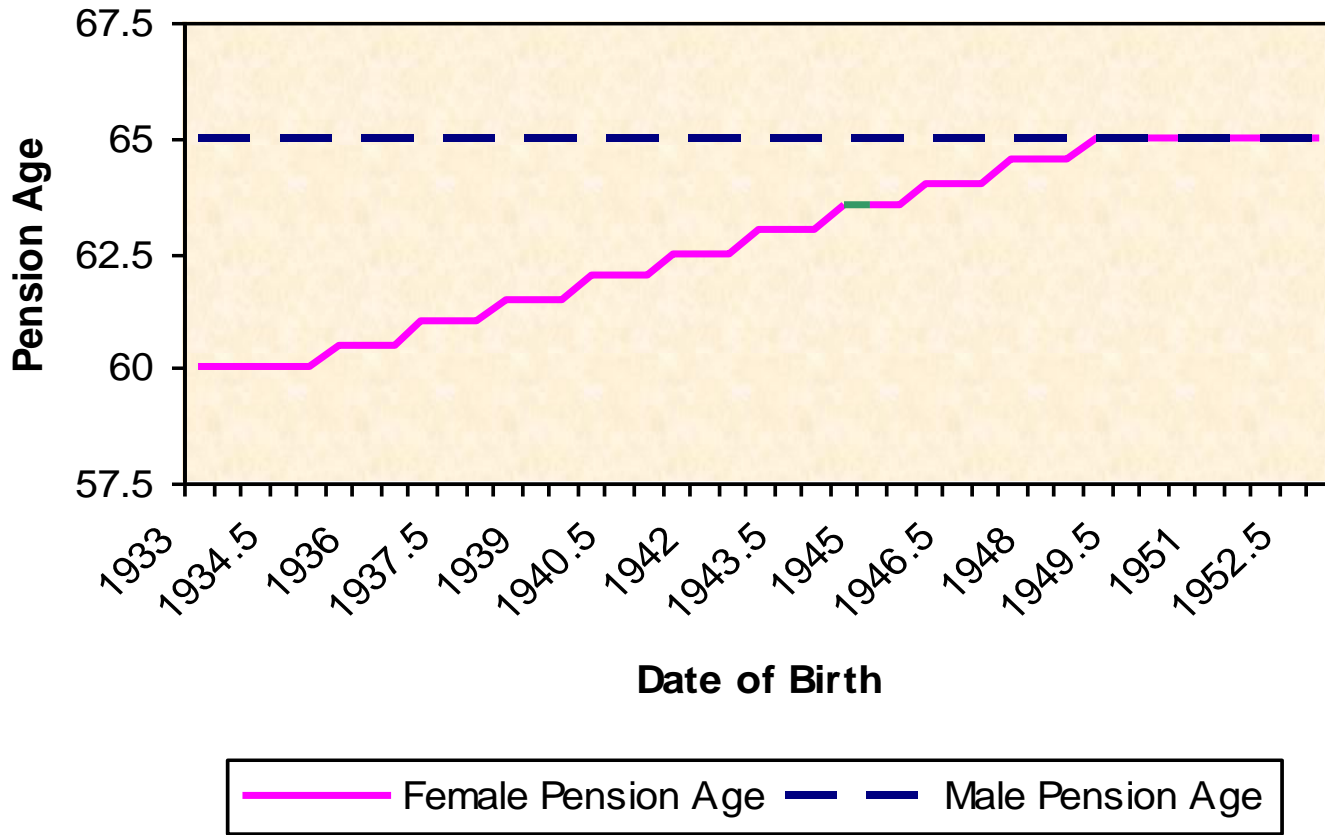
“increasing pension eligibility ages will improve
financial sustainability and retirement incentives”

OECD

We are living longer after 65

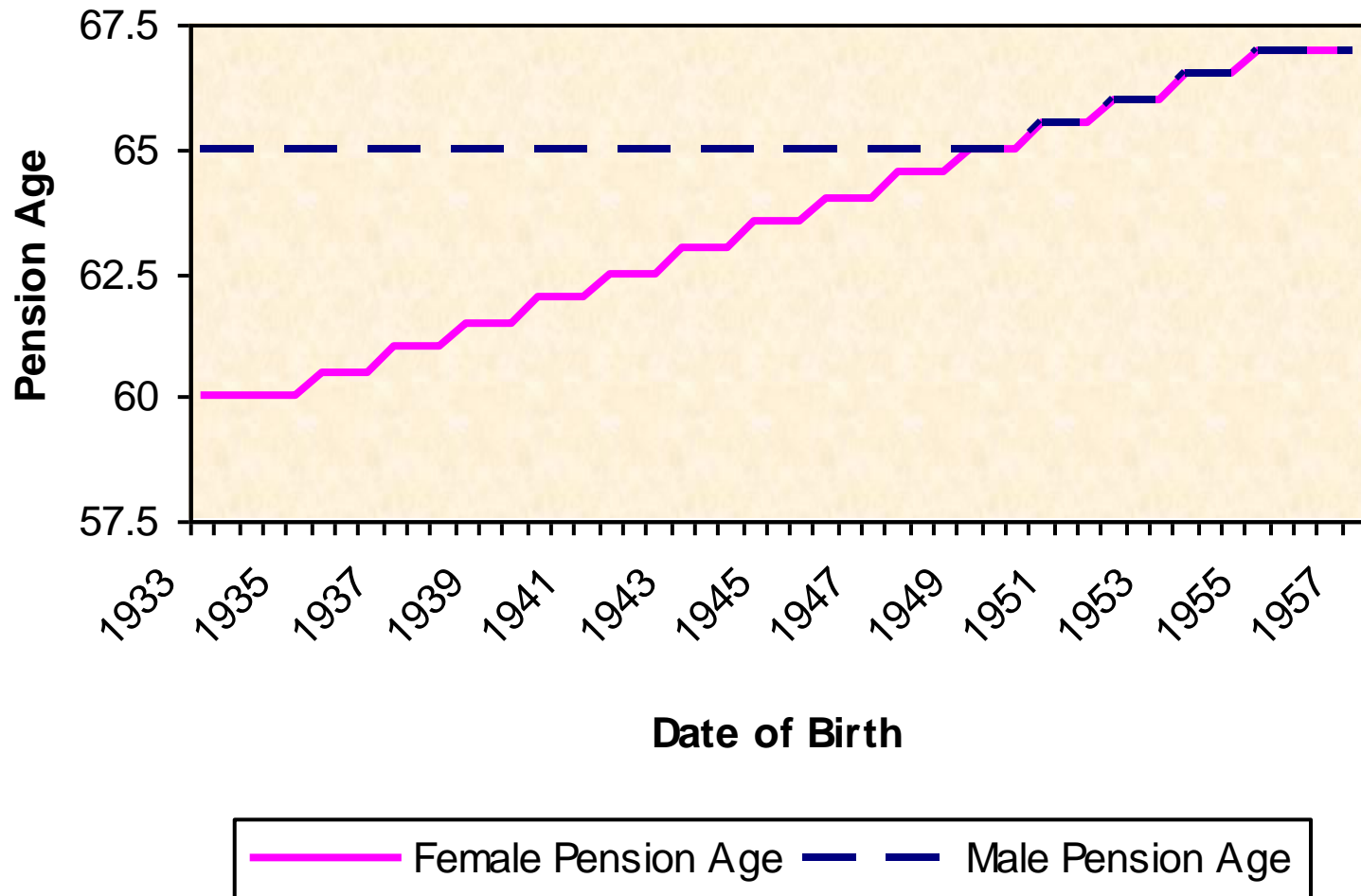


What is happening today?



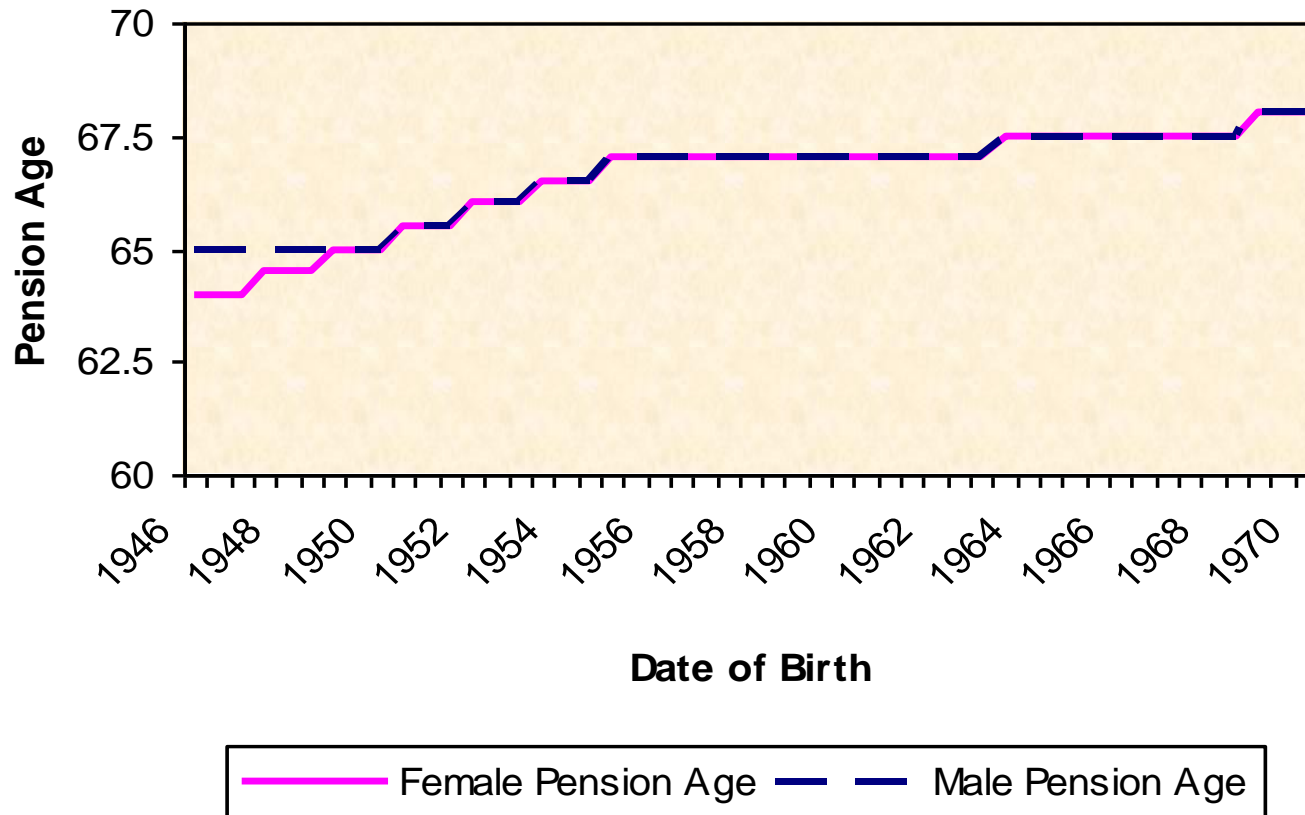
What should we do?

Step 1: Announce a planned increase to age 67



What should we do?

Step 2: adjust the pension age with 50% of any change in life expectancy at age 65



Some effects of a higher pension age

- **Age 65 would no longer be “the age”**
- **A more dynamic approach to the concept of retirement**
- **Encourage later retirement**
- **Increase the tax free age (eg pension age - 5)**
- **Improve the sustainability of our retirement income system**
- **Some net savings – approx \$800 mill pa**
- **An increase in the number of Disability Support Pensioners**

Super and retirement ages

- **Preservation age increasing from 55 to 60**
- **Benefits are tax free after age 60**
- **Contributions are permitted to age 65 without a work test**
- **Compulsory SG contributions required for employees under age 70**
- **Spouse contributions permitted if spouse under age 70, subject to the work test after 65**
- **Co-contributions available if employee aged 70 or less at end of FY**
- **Contributions can be made up to age 75, subject to the work test**

How to improve adequacy?

+ Employer	Have we reached the limit?
+ Employee	Limited take up
+ Government	Co-contributions
+ Investment earnings	Market related
- Taxation	Henry Review
- Expenses	Competitive market
Benefit payments	Any preferences?

Member contributions

	Hard	Soft
Equity	Does everyone need it?	Opt out provision
Efficiency	Simpler	More complex
Behaviour	Accepted?	Inertia
Solution?	Compulsory for income above \$X	

To sum up

- **What are the objectives?**
- **How do the 3 pillars fit together?**
- **We are living longer – consequences?**
- **No one is average!**
- **How do we encourage/require more contributions for some or all?**
- **How should post-retirement outcomes be further developed?**



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Questions and discussion

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