Institute of Actuaries of Australia

Super Policy Forum

19 February 2009

What objectives are relevant in setting retirement income policy?

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Agenda

- What is a retirement income system trying to do?
- How are these objectives 'best' met?
- What are the ideal characteristics of a retirement income system?
- Can replacement rates help?
- How do we measure up?
- What needs to change?

Two extreme outcomes from a retirement income system

- **Option A**
  - **Poverty alleviation only; say 20% of AWOTE**
  - **Means tested age pension**
  - **Publicly funded pension only**

- **Option B**
  - **Indexed income of 80% of pre-retirement income for life**
  - **Publicly funded or mix of private/public funding**
  - **Some guarantees must be publicly funded**

A verdict on these 2 options

Option	Verdict
Option A • means tested basic pension • public funding	Not good enough for a civilised society No encouragement to save
Option B • indexed income at 80% • mixture of funding plus guarantees	Too expensive Not financially sustainable

What did the World Bank (1994) say in "Averting the Old Age Crisis"?

- Old age security programs should help the old by (my *italics*):
  - Facilitating people's efforts *to shift some of their income* from their active working years to old age
  - *Redistributing* additional income to the old who are lifetime poor
  - *Providing insurance* against the many risks to which the old are specially vulnerable.
- And they should help the broader economy

Then in 2005, in "Old Age Income Support in the 21st Century"

Holzmann and Hinz (World Bank) said:

- **The continued relevance of the main objectives of pension systems – *poverty alleviation* and *consumption smoothing* – and of the broader social goal of *social protection***

- **All pension systems should, in principle, have elements that provide basic income security and poverty alleviation across the *full breadth* of the income distribution.**

Therefore the objectives of a retirement income system are

1. Poverty alleviation = a minimum income for all
2. To provide mechanisms to smooth one's income over one's whole lifetime
3. The provision of some mechanisms by the Government to protect retirees from certain risks eg inflation, investment, longevity, public policy, system failure

How should these objectives be achieved?

- There are a range of risks and objectives for the long term

Holzmann and Hinz again …

The positive news

- "experience has demonstrated that the multi pillar design is better able to deal with the multiple objectives of pension systems … and to address more effectively the kinds of economic, political and demographic risks facing any pension system. The proposed multi pillar design is much more flexible"

Now the negative!

- "most pension systems in the world do not deliver on their social objectives, they create significant distortions in the operation of market economies, and they are not financially sustainable when faced with an aging population."

The World Bank multi pillar system

Pillar	Description
0	**A non-contributory Government funded basic pension**
1	**A mandatory contributory public pension with modest benefits**
2	**A mandatory occupational or personal pension**
3	**A voluntary occupational or personal pension with flexibility**
4	**Non-financial assets eg informal support, home, social programs**

“Australia has all these elements except for the mandatory first pillar, which is equivalent to a social insurance model.” Consultation paper, p45

So what does a multi pillar approach lead to?

- A mix of funding – some public, some private
- Several components which may serve different objectives
- A danger of imperfect integration - indeed from the Consultation paper
  - “Although the three pillars (in Australia) are referred to as the retirement income system, in many ways the pillars have developed independently of each other.”
  - “The history of the system has influenced the degree of integration between the pillars.”
- A multi pillar system may be ideal but integration is difficult and can have adverse incentive effects.

What are the characteristics of an ideal system?

Overall design

- Adequate – protects the poor and provides mechanisms to save
- Sustainable – financially sound over the long term
- Robust – able to withstand shocks to the system

Interaction with individuals/community

- Transparent – simple and approachable
- Accepted by society
- Equitable
- Affordable by individuals; attractive and flexible

Note: Referred to as objectives in Consultation paper

Some secondary objectives or goals

- Minimises hidden costs
  - Excessive fiscal burden
  - Misallocation of capital
  - High administration costs
- Minimises negative impact on labour market
  - Particularly relevant within an ageing population
- Rewards risk taking and development of capital markets
- Recognises that we are not all the same
  - Ensure some flexibility
- Enables reasonable levels of retirement income to be provided

What are reasonable levels of retirement income?

- 65 @ 65?
- Consultation paper, Table 1.1, Net replacement rates at today's age
- Some clear trends linked to today's age and income levels

	Individual's age in 2008		
Income	60	40	20
75% AWOTE	**63%**	**83%**	**89%**
100% AWOTE	**54%**	**73%**	**78%**
150% AWOTE	**43%**	**61%**	**67%**
250% AWOTE	**30%**	**49%**	**60%**

Note: work for 45 years; deflated at CPI

Some OECD comparisons for males

Country	Level of income as % of mean				
	50%	75%	100%	150%	200%
Australia	83.5%	**66.2%**	**56.4%**	**46.1%**	**40.8%**
Japan	**52.5%**	**43.5%**	**39.2%**	**34.3%**	**31.3%**
Norway	**77.1%**	**71.2%**	**69.3%**	**62.5%**	**55.1%**
UK	**66.1%**	**49.2%**	**41.1%**	**30.6%**	**24.0%**
US	**67.4%**	**58.0%**	**52.4%**	**47.9%**	**43.2%**
OECD average	**83.8%**	**74.0%**	**70.1%**	**65.4%**	**60.7%**

Source: OECD, Pensions at a Glance, 2007

How do we measure up?
The objectives

Objective	Comment	Score (subjective!)
Poverty alleviation	Good	9
Mechanisms to smooth income	SG in place though not universal Income products limited; no real smoothing	6
Protection of risks facing retirees (eg inflation, investment, longevity)	Nothing in super system Age pension acts as limited insurance for some	3

How do we measure up?
The characteristics

Characteristic	Comment	Score (subjective!)
Adequate system	Age pension; SG system but missing bits	7.5
Sustainable	Limits long term costs to Government	9
Robust	Limited support when shocks occur	4
Transparent	Much complexity with means tests and taxation	2
Accepted	Age pension and SG supported	8.5
Equitable	Some inequities in tax support	5
Attractive and flexible	Attractive for some but not for many; relatively flexible	5

How do we measure up?
The secondary objectives

Goal	Comment	Score (subjective!)
Minimise hidden costs	Reasonable admin costs Some misallocation of assets	7
Labour market	Current arrangements discourage participation at older ages	3
Risk reward trade-off	Capital markets have developed but many risks left with member	6
Recognise flexibility	OK but lack of products	8
Reasonable levels of retirement income	Caps limit income for some Lack of member contributions Considerable risks faced by retirees	4

Some suggested changes to make the system more efficacious

- Simplify the means tests and taxes
  - Remove double effect
  - Improve encouragement for labour market involvement
- Introduce a universal age pension from age 85 (currently)
  - Availability: age pension age + 20
  - Government support for long term risks
  - Limited costs
  - Improves attraction of saving
- Close the SG gaps
  - Improves benefits and integration
- Encourage member contributions with soft compulsion
  - Involvement and flexibility
- Introduce broader range of Government securities
  - Enable a broader range of income products to address inflation and longevity risks