Options for an Improved and Integrated System of Retirement

GREEN PAPER
AUGUST 2019

About the Actuaries Institute

The Actuaries Institute ('the Institute') is the sole professional body for Actuaries in Australia. The Institute provides commentary on public policy issues where there is uncertainty of future financial outcomes. Actuaries have a reputation for a high level of technical financial expertise and integrity. They apply their risk management expertise to allocate capital efficiently, identify and mitigate emerging risks and help maintain system integrity across multiple segments of the financial and other sectors. This expertise enables the profession to comment on a wide range of issues including retirement income policy, general insurance, life insurance, health insurance, enterprise risk management and prudential regulation, and finance and investment. Our public policy principles can be viewed at: https://actuaries.asn.au/public-policy-and-media/public-policy/policy-principles.

This Green Paper is an initiative of the Actuaries Institute's Public Policy team and was written by Anthony Asher, David Knox and Michael Rice. It draws on three Papers presented at the Actuaries Financial Services Forum in May 2018, namely:

- The Age Pension means test: contorting Australian retirement (Dr Anthony Asher & John De Ravin)
- Retirement Incomes – Australia vs the Rest of the World (Dr David Knox)
- The Age Pension in the 21st Century (Michael Rice)

It also reflects feedback received from a roundtable and a presentation at the June 2019 Actuaries Summit.

Contents

Executive Summary

A world-leading system would take an integrated view across the major sources of income and expenses for retirees, including the Age Pension, superannuation and non-superannuation savings (including the family home), aged care and health costs (including pharmaceuticals). The current system, though world-leading in some aspects, falls well short of that.

Our retirement system is good – but it could be, and should be, much better and fairer for all.

Context

It is timely to consider Australia's retirement system. Although Australia's structure for retirement incomes compares well internationally, there are obvious shortcomings – the system is complex, intrusive, contains anomalies, produces perverse incentives and is sometimes unfair.

These shortcomings will become even more apparent as an increasing proportion of the population and member balances move from an accumulation phase to a pension phase. There is also potential fiscal headroom to accommodate some changes, especially when a holistic approach is taken to retirement.

In approaching such an opportunity, we have begun by considering what the objectives should be for Australia's retirement system. The Actuaries Institute believes the overarching objective should be to ensure that Australians can confidently live their retirement years in dignity. At a minimum, it will require better integration of the current disparate Age Pension and superannuation systems, but it can go much further and better integrate with our aged care and health care systems.

In assessing any proposals for reform against such an objective the Institute has considered three guiding principles:

- Australian retirees should have financial security;
- the system should be efficient without unnecessary complexity or costs; and
- it must be fair.

Options

This paper then outlines some design options for an integrated system of retirement provision, which the Actuaries Institute encourages Australians to debate boldly. The key options identified in this paper are:

- Simplifying the Age Pension (including through changes to means testing[1] or introducing some universal benefits).
- Addressing the anomalies and perverse incentives in the treatment of the family home.
- Embedding automatic adjustments to reflect changes in longevity in both the superannuation Preservation Age and the Age Pension eligibility age.
- Setting targets for government support in retirement in terms of government expenditure.
- Addressing taxation and funding anomalies created by unusually large superannuation balances and at end of life.
- Coordinating retirement, pension and age care policies, or calibrating social security benefits and living standards.

A combination of these options is likely to deliver an improved retirement incomes system that is simpler to understand, sustainable and has community support.

This paper identifies six key options for improving our retirement system.

Next steps

The Actuaries Institute looks forward to a robust discussion involving all stakeholders. Ultimately, at stake is the opportunity to deliver landmark reforms which will deliver a better quality of life to Australian retirees in a way that is efficient and fair for all Australians.

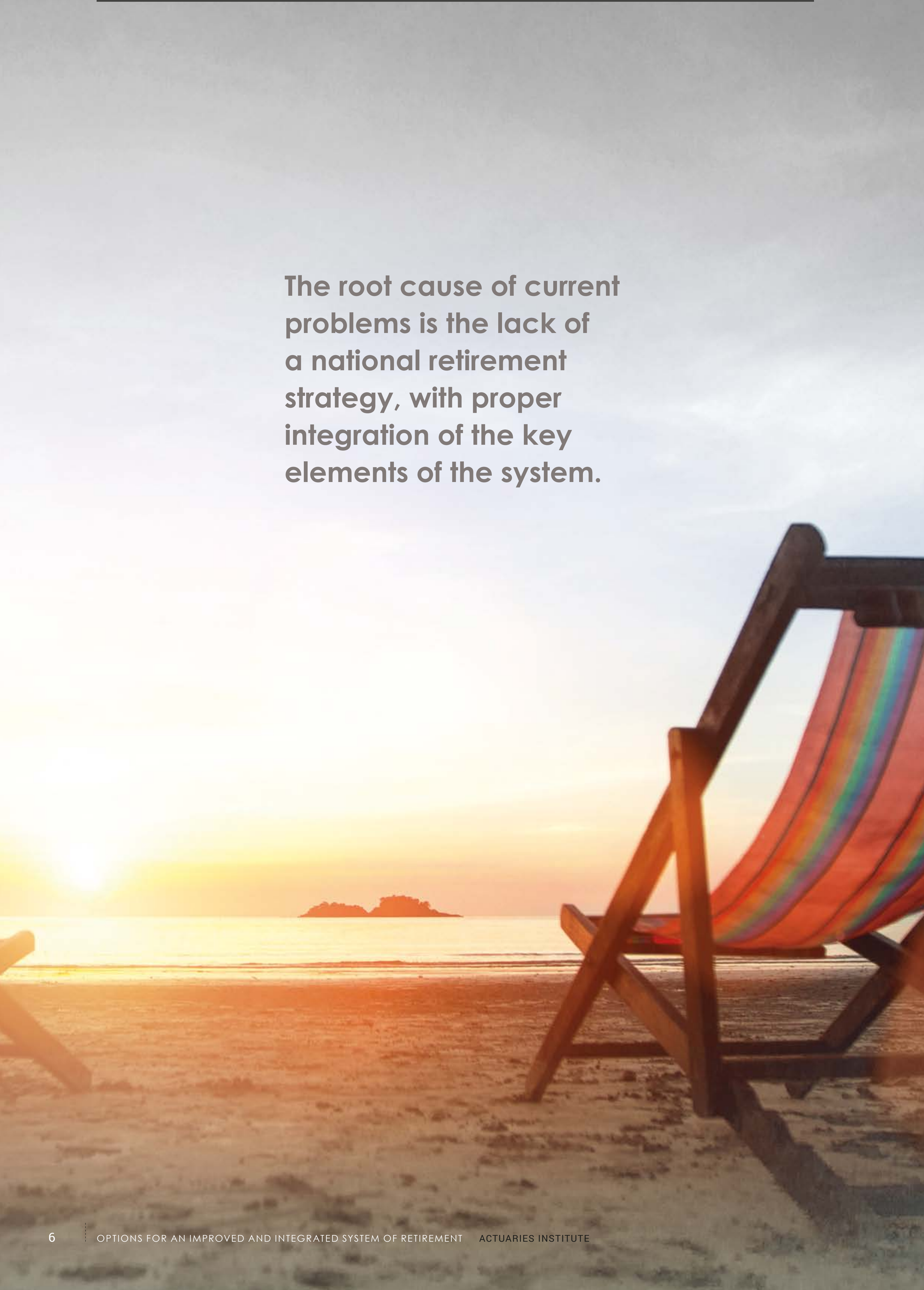
The Actuaries Institute encourages that debate to start now. If it does not, Australians may lose the opportunity presented by the fiscal headroom of the projected declining Age Pension costs, and the lead time we have to prepare for known longer-term changes such as patterns of home ownership and work, longevity, and growing health and aged care costs.

The process should involve a period of broad and informed debate to refine the options and establish consensus for the solution that best fulfils modern Australian society's values.

Importantly, the Actuaries Institute acknowledges there will be significant transition issues dependent on the solution chosen. Finding the optimal path to that solution will require transition arrangements which ensure plans for those approaching retirement are not overly disrupted. Further, as a general principle, changes should not disadvantage those who have already retired.

The Actuaries Institute welcomes feedback on the ideas advanced in this Green Paper by sending comments to actuaries@actuaries.asn.au.

1 This option was strongly supported at the 2019 Actuaries Summit.



The root cause of current problems is the lack of a national retirement strategy, with proper integration of the key elements of the system.

Context

1

Through this Green Paper the Actuaries Institute ('the Institute') seeks to stimulate a high-level discussion about the structure of the retirement system. The Paper is not a blueprint for the optimal design of integrated retirement provision. Rather, it is intended to raise questions and provide a catalyst for the generation and discussion of ideas to help policymakers and stakeholders work towards a fair and efficient longer-term design that provides financial security.

1.1 Why reform is crucial

The Institute is taking this step because it is widely agreed that the current arrangements for retirement provision create unnecessary uncertainty and are complex, inefficient and often unfair.

General uncertainty about financial security in retirement causes many retirees to be too frugal and risk averse with a consequential lower living standard than could be achieved otherwise. These uncertainties are aggravated by ongoing changes to the three key elements of the system: Age Pension, superannuation and aged care. These have often been based on short-term fiscal considerations, without adequate consideration of the overall impact on system design.

Frequent change is disruptive and hinders people's understanding and engagement. If the system could be stabilised, reviews could be conducted every five years to ensure changing circumstances can be considered. For example, these reviews could follow the release of the Intergenerational Reports.

The root cause of these problems is the lack of a national retirement strategy, with proper integration of the key elements of the system. Policies and settings have been treated disparately and have not been developed within an overall objective and framework of standards. The resulting complexity makes navigation challenging, there are conflicting and some perverse incentives, and some people, particularly renters, appear to be falling through the gaps.

Furthermore, absent clarity on the overall objective and mechanisms to ensure integration and measure its success, the retirement system is likely to remain inefficient. There are a number of known longer-term trends – population ageing, the maturing of the superannuation system, changing patterns of home ownership and work, a growing dispersion in wealth and health, changing longevity, and growing private costs for health and aged care – that will fundamentally challenge the stability of the current system. All of these will aggravate the inconsistencies that stem from a lack of appropriate integration between the various components.

General uncertainty about financial security in retirement causes many retirees to be too frugal and risk averse with a consequential lower living standard.

1.2 The Institute's proposals

The Institute posits that the overarching objective of the retirement system should be to ensure that Australians can confidently live their retirement with dignity (refer Appendix A for further discussion of objectives).

This requires the retirement system to provide for appropriate financial resources in retirement. This would include an income adequate to provide not only for basic needs, but also for a standard of living comparable with that they enjoyed while working, and with members of their families and communities. It would also provide for contingencies, particularly arrangements to cover health and aged care costs.

The options for reform in this paper are focused on these financial issues. At this stage, the Institute has not included any modelling as the discussion has been deliberately kept to a high level across a wide range of options to identify which option/s have enough *in principle* support to be further developed. Modelling will be an essential part of any further refinement of the options to ensure that the overall design is sufficiently robust to withstand a range of future scenarios.

The Institute's main objective in this paper is to begin the process of consensus building for significant change that will see a more robust and effective system that provides retirees with dignity.

1.3 Strong underlying structure

The current system has almost all the necessary elements to meet retirement needs while playing an appropriate role in the economy. While the level of benefits may be debated - some inadequate, some excessive - the underlying structure is sound.

- The Age Pension is payable to all those who need it and is adapted to meet the particular needs of renters. It is also set at a level that, on an international comparison, is not a disproportionate share of national income (see top of p25), and so makes no unreasonable and destabilising promises.
- The superannuation system covers almost all Australians and offers opportunities to safely provide supplementary income in retirement. It is funded and contributes significantly to diversity and resilience in Australian capital markets. It also makes no unreasonable promises, so does not expose employers to the risks of defined benefit funds (i.e. guaranteed retirement benefits).
- There are different levels of aged care available to cover the different needs of patients.
- The taxation system applies to contributions and investment income, so reducing the strain on government cash flows.

Missing are appropriate products for the management of the risks in the pension phase, but the possible movement towards a retirement income covenant should help address this shortcoming.

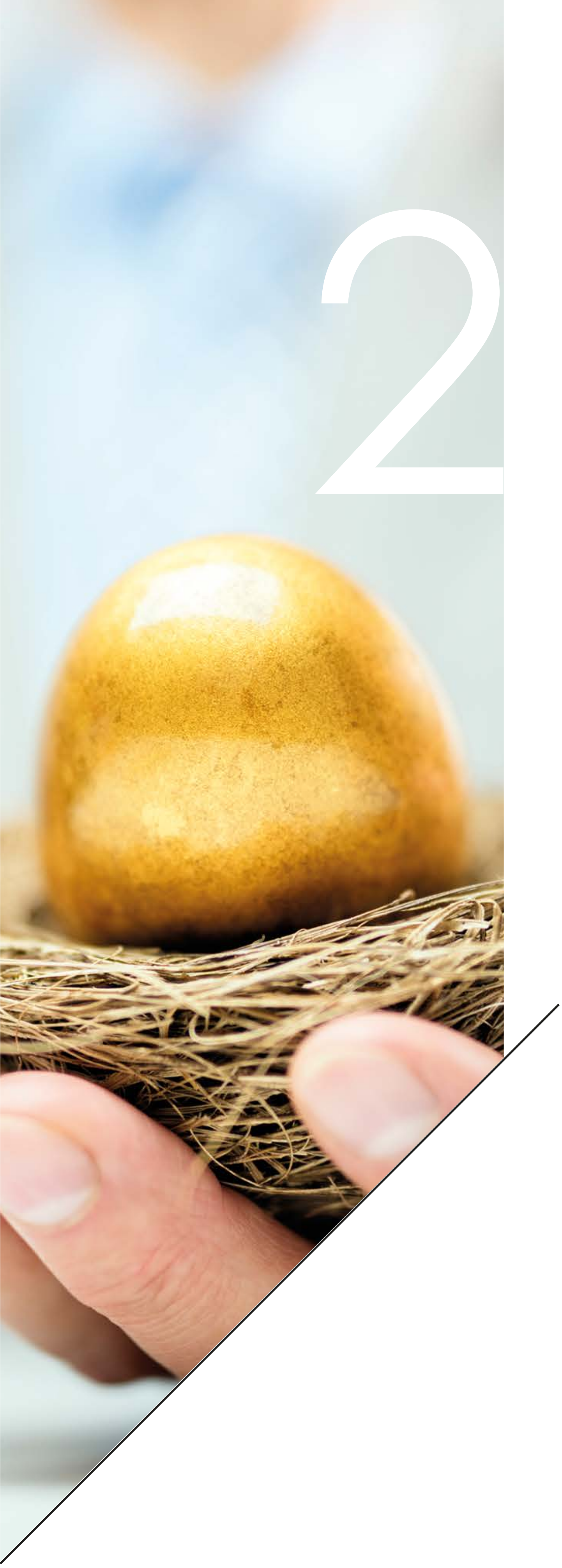
1.4 Issues out of scope

As this is a high level paper considering all the major sources of funding and how they could be better integrated, it does not consider a range of detailed, yet important, issues that are currently being discussed relating to the superannuation system. Such issues include the coverage of the compulsory system, the level of Superannuation Guarantee (SG) contributions, the role of insurance within superannuation, the specific development of Comprehensive Income Products in Retirement (CIPRs), the role of financial advice, specific taxation measures, investment strategy, issues arising from the recent Productivity Commission Inquiry into Superannuation[2], and implications from the recent Royal Commission[3].

Nor does the paper extend to employment law, and industrial relations more generally, and the impact those frameworks have on superannuation.

The paper also does not extend into long-term care insurance and the issues being raised in the current Royal Commission into Aged Care Quality and Safety, although there may be learnings from the Commissioners' final report.

2 Productivity Commission, 2018.
3 Final Report – Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Commonwealth of Australia, 2019.

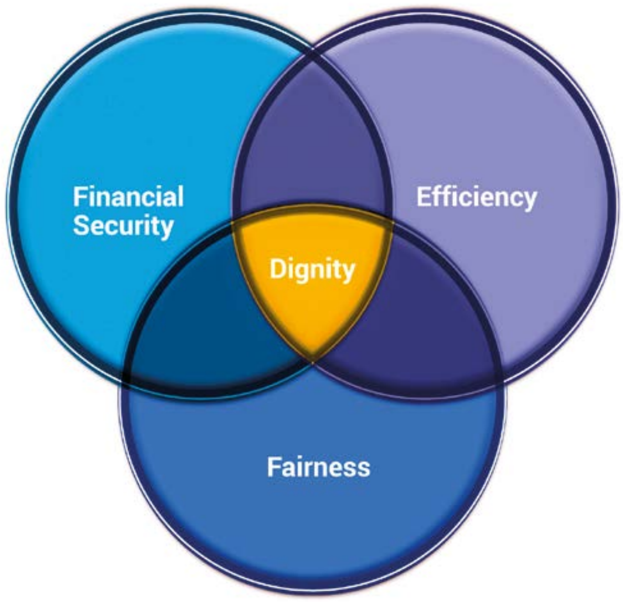


Three fundamental principles for a strong retirement system

The Institute proposes a system of integrated retirement provision to meet the overarching objective of ensuring Australians can confidently live their retirement with dignity. The system should meet the three principles of financial security, efficiency and fairness, whilst contributing to and not undermining the dignity of all participants in the system.

Any policy initiatives leading to changes to improve the current arrangements underpinning retirement provision should be assessed against these principles.

Figure 1: Three fundamental principles for a strong retirement system



2.1 Financial security

The vast majority of Australian retirees should be financially secure and have the opportunity to maintain the living standard throughout their retirement which they had enjoyed during most of their working lives.

- Retirement income policy settings, products and services must help retirees confidently resolve the difficult choices they face between ensuring they have access to a regular income stream, a pool of capital which can be drawn upon for large, irregular and potentially unexpected expenses, such as out-of-pocket medical costs and travel, as well as protection against risks such as longevity, inflation and market risk. The difficulty reconciling these three objectives is sometimes called the retirement income trilemma.
- As part of protection against risks, the government should ensure that those who have been unable to provide for themselves in retirement receive a safety net sufficient to protect against poverty and to provide some dignity in retirement. This requires maintaining the Age Pension, and a base level of government coverage for the costs of aged care, health costs and pharmaceuticals, consistent with community expectations.
- Retirees should also have better options than those currently available to protect against longevity risks. The Institute is hopeful the development of CIPRs will promote such options.

The current system has been subject to frequent changes which have contributed to complexity, consumer doubt and inefficiencies.

2.2 Efficiency

The retirement system should be efficient. The current system has been subject to many changes which have contributed to complexity, consumer doubt, sub-optimal decisions and varying outcomes.

There are several ways of looking at efficiency. For the purposes of this paper we are focusing on the efficient production of retirement income from both the Government's and consumers' perspectives.

Outcomes for consumers should be set at the lowest reasonable cost to consumers and government. This includes:

- Superannuation and pension products should provide strong value to the superannuant.
- Government support should be delivered to people in genuine need and at an acceptable cost to the community.
- The behavioural incentives of individuals and households should be aligned with the objectives of the government and the community:
    - where self-provision is encouraged;
    - incentives to 'game the system' to maximise the receipt of government benefits or reduce taxation are avoided; and
    - 'strong and smart' default settings are provided for individuals who do not want to exercise choice for income and asset management.

Retirement income products should have high 'income efficiency' (a concept considered in the Financial System Inquiry[4]). That is, the savings accumulated in an account should be able to support a reasonable level of income and consumption in retirement, avoiding and discouraging the extremes of frugality or leaving of non-trivial bequests.

The system should be as simple as possible to enable consumers to confidently understand, plan for and implement their retirement with sensible choices. The simpler the system, the greater will be the capacity of individuals to confidently make their own informed decisions rather than having to rely on advice from others.

4 Commonwealth of Australia, 2014.

The cost of implementing change to the system should be minimised and disruption should be avoided.

- Change should be minimised and where it does occur it should be predictable, for example indexation.
- Any significant change should be foreshadowed with a reasonable lead time until its introduction.
- There should be a distinction between the structure and the parameters of the system such that the former should seldom be changed, while the latter should be adjusted, incrementally, as circumstances change. Retirement requires long-term planning but significant changes to structure disrupt people's plans. On the other hand, it needs to be recognised that marginal adjustments to tax rates and benefits will be required from time to time when members, retirees and pensioners are required to contribute to fiscal stability.

2.3 Fairness

The cost to the government, and therefore taxpayers, of total retirement provision must be shared equitably between and within generations.

- To ensure intergenerational equity, the cost to the government, and therefore taxpayers, of integrated retirement provision should not be projected to place an unfair burden on future generations under all reasonable scenarios.
- The system must also provide intragenerational equity for retirees.
- Retirees who can least provide for themselves should be given more government support and this support should be withdrawn at a reasonable rate as financial capacity increases (vertical equity). It is reasonable to expect a government and taxpayers to provide significant support to those with no or low incomes, so they can live with dignity.
- Retirees with similar economic circumstances should receive similar support (horizontal equity).
- It is acceptable to provide financial support to encourage people to defer their consumption now to fund their retirement later. This is partly to address a reluctance to consider future needs, but also to compensate for a lack of access to funds while working. Disincentives (in the form of penal means tests or taxes) are undesirable.
- As people have been required to make contributions to superannuation from their wages, they deserve a higher post-retirement standard of living than they would have received without these contributions.
- Equally, it is reasonable to expect that the government and taxpayers limit support for those who have had high incomes during their working lives.
- Expressed more generally, taxation and social security payments, including support in retirement, should be considered holistically over a person's lifetime. Some parts of the system may be less progressive than others in the interests of financial security and efficiency (as defined above) – provided the system, as a whole, is fair.

The cost to the government, and therefore taxpayers, of total retirement provision must be shared equitably between and within generations.

3 Some relevant longer-term trends

A sound retirement system will need to be dynamic and able to adapt to societal change.

In designing a system that will be robust in the face of social, economic or demographic changes, it is useful to note recent trends that have and will continue to affect Australians in retirement. A sound system will be dynamic and require change from time to time (within the principles outlined in Section 2). This section notes seven currently identifiable trends.

3.1 The loss of long-term confidence and trust

The provision of retirement income through superannuation savings is a long-term venture over decades.

Unfortunately, the process and findings of the recent Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry have undermined long-term confidence and trust in institutions operating in the retirement income system.

The frequent changes to superannuation taxation and Age Pension structures and rules over the last 36 years have increased complexity and worked against providing confidence and trust to Australians to plan for their retirement.

This paper is advocating consideration of further changes, but as a move to improvement; we also advocate more stability and fewer changes in future. The adoption of the three fundamental principles, together with an overarching objective, should provide a sustainable system giving greater confidence.

3.2 Changing home ownership

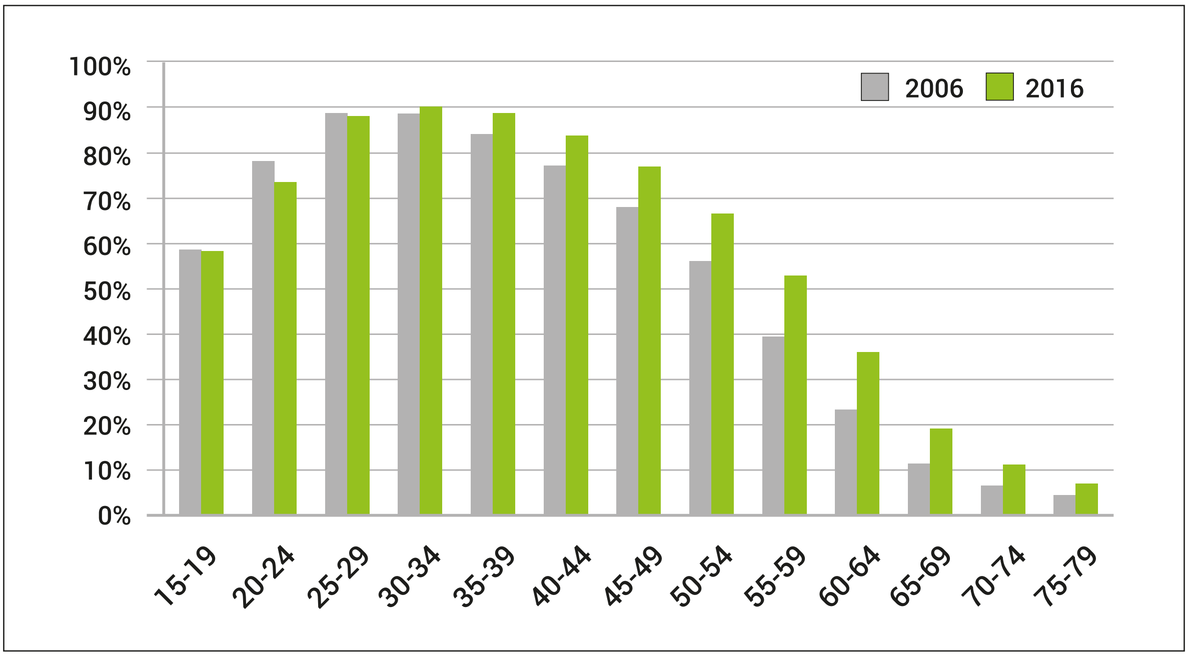
A system of integrated retirement provision needs to adapt to the changing pattern of home ownership.

There is an impending wave of retirees who will enter retirement as renters because home ownership has remained elusive. This higher proportion of renters is likely to persist across future generations unless housing affordability improves considerably. The needs of retirees who rent are very different from those who own a home given the vast difference in regular expenses on basic needs. Single pensioners who rent in the private market are poorly served by current arrangements. In fact, the ARC Centre of Excellence in Population Ageing Research (CEPAR) states 60-70% of older single people who rent private housing live in poverty.[5]

Those retirees who own their home are in a more advantageous position than those in previous decades. Due to the long-term growth in property prices, the value of the home has far outgrown the value of many other assets. This provides a higher level of absolute wealth for retirees, but it is illiquid. This can be a dilemma for retirees, particularly those with limited other savings. Many may not wish to 'right size' to gain access to liquid savings because there is no suitable housing in their area. In addition, some will also need to consider possible reduction in Age Pension eligibility and other government support.

Furthermore, those retirees who own their own home increasingly do so with a mortgage at the time of retirement. This proportion has been increasing over time, from 23% in 2006 to 36% in 2016 for those aged 60-64 years, and even higher rates for those in the younger age group (Graph 1).[6]

Graph 1: A growing number of people have a mortgage on their home at the time of retirement



Source: Chomik, Graham, Yan, Bateman & Piggott, 2018b, p.45 and additional data provided

Of note, it appears that while the median debt to income and median debt to asset ratios for 55-64 year olds have been increasing over that time[7] , the ratios remain low suggesting the size of mortgages on principal residences (and any other debt) is modest.

Given this development, it seems reasonable to expect a growing number of Australian retirees will use part of their superannuation balances at retirement to pay off their mortgage. These trends will likely only reverse if there are significant changes to housing affordability. As a result, while superannuation will be an increasing proportion of people's wealth in future cohorts[8] , it is

5 Chomik, Graham, Yan, Bateman, & Piggott, 2018a, p. 24.

6 Chomik, Graham, Yan, Bateman, & Piggott, 2018b, p.45. This is also consistent with Ong & Wood, 2019.

7 Australian Bureau of Statistics, 2017b, Table 3.5.

8 Actuaries Institute, 2015, p. 29.

Superannuation may need to be used to extinguish or service debts, including mortgages.

likely there will be a need in some households for it to serve purposes other than provide an income in retirement – it will also need to extinguish debts on retirement (or service them during retirement).

3.3 Growing dispersion in wealth

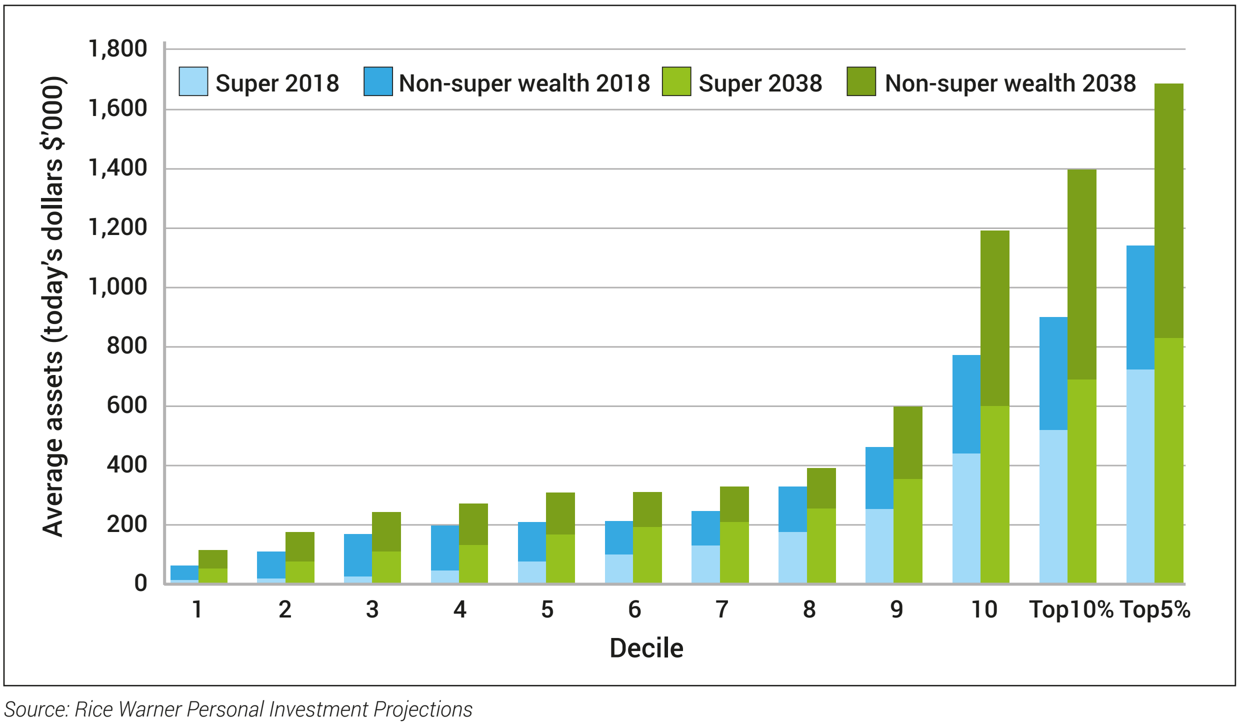
The highest income deciles in our society tend to hold much more in non-superannuation assets than the general population. Graph 2 demonstrates this distribution both today and in 20 years' time based on projections from Rice Warner.

The results show that the top decile hold more than 2.5 times the fifth decile in non-super wealth today. This disparity is expected to increase to five times in 2038.

Overall wealth that includes superannuation savings will not see as large a growth in disparity, as those on middle incomes are largely expected to substitute some private savings/consumption for superannuation as the compulsory rate of superannuation contributions rises to 12%.

Most of this non-superannuation wealth is held either in investment properties or term deposits, so it will often provide regular income in retirement.

Graph 2: Distribution and composition of wealth by income decile



Source: Rice Warner Personal Investment Projections

3.4 Changing life expectancy

Life expectancy, both as measured from birth and at retirement, has continued to improve. Therefore, the expected number of years retirees need to fund is growing as shown in Graph 5 in Section 5.3. For those aged 60 to 90 years, mortality rates have been on a rapidly improving trend since the 1970s (i.e. death rates have decreased) due to medical advances[9] and lifestyle changes, with the improvements strongest for those in greater capital city areas[10]. The healthy life expectancy (that is the years lived free of a disability or a severe or profound core activity limitation) have also been increasing[11]. The effect is that a greater proportion of the population should expect to live well into their mid to late 80s or beyond.

9 Australian Government Actuary, 2014, p. 9. That said, mortality rates for those aged 90 years and over have deteriorated (death rates have increased). The Australian Government Actuary (2014) has noted the improvements in mortality for 60-90-year ages have led to an increasing proportion of the population living to the older years which may have contributed to the decline in average health of the older age group.

10 Australian Bureau of Statistics, various dates. Note that the ABS data by Statistical Area Level 4 is only available for the period from 2009-11.

11 Australian Institute of Health and Welfare, 2014.

However, there is also evidence[12] in several developed economies that the increased life expectancy may have slowed or even stalled. This result may be caused by several reasons, including an increasing difference in life expectancy between different socio-economic classes.

A natural consequence of a growing dispersion in wealth is a growing diversity in health outcomes, including for life expectancies.

3.5 Growing health and aged care costs

An integrated system needs to cater for the likely significant growth in health and aged care costs. These costs are growing in real terms (i.e. faster than inflation and conservative investment returns) because of higher standards of care (increasing per unit cost) and the larger number of older people from increased life expectancy and the baby-boomer generation. CEPAR reports estimate that public spending on aged care will rise from 1% of Gross Domestic Product (GDP) to over 2% by 2050.[13]

Longer term projections show aged care is the second fastest growth category of expenditure (behind the National Disability Insurance Scheme).[14] For aged care, the (Commonwealth) government meets around three-quarters of total costs and individuals meet less than one-quarter.[15] Furthermore, aged care providers may ask for (but no longer demand) significant lump sum payments by individuals if residential care is required. Meeting these costs may require release of equity from the family home. Given life expectancy improvements, the lifetime risk of needing to enter permanent residential aged care is increasing. Most recently (in 2014), for a person aged 65 this risk has been estimated at 42.8% for men and 59.3% for women (up from 33.5% and 53.8% respectively in 2000).[16] These percentages are likely to increase with ongoing mortality improvements.

Reflecting this, Budget projections show a very strong growth in Commonwealth government costs (Table 1).

12 See for instance, https://www.ons.gov.uk/peoplepopulationandcommunity/birthsdeathsandmarriages/lifeexpectancies/bulletins/nationallifetablesunitedkingdom/2015to2017
13 Chomik & Townley, 2019.
14 Parliamentary Budget Office, 2018.
15 Tune, 2017, p.8.
16 Cullen, 2019, p.16.
17 Commonwealth of Australia, 2019 - Budget Papers 2019-20 Statement 5, p.5-23.

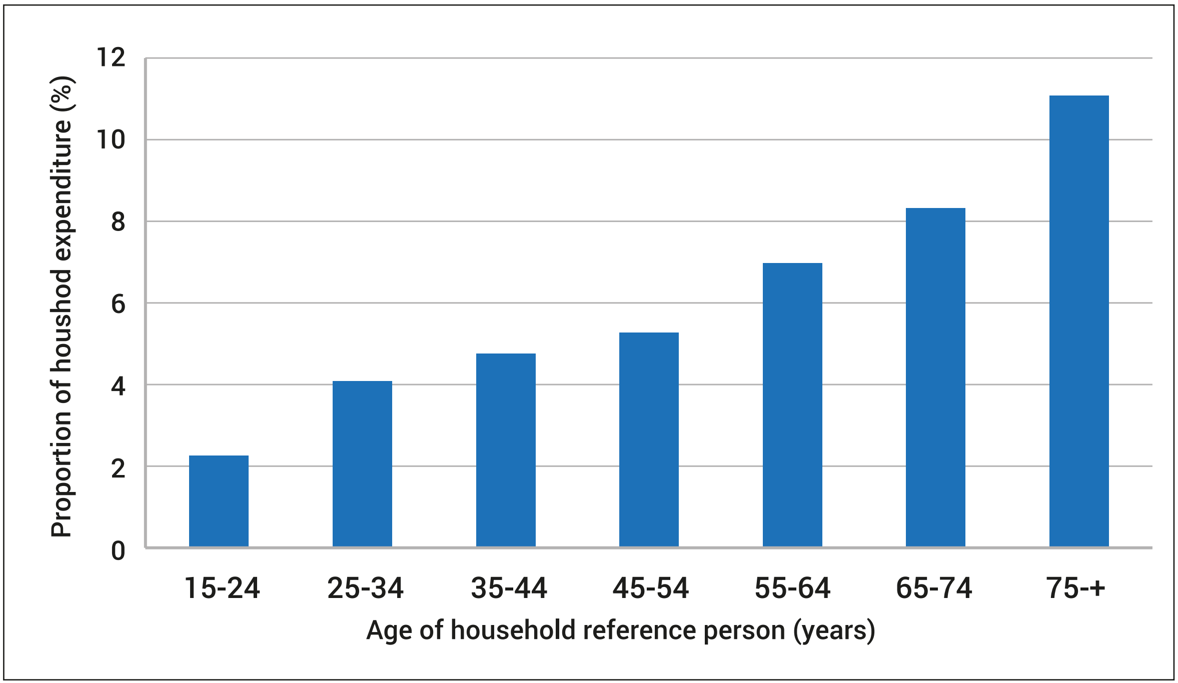
Table 1: Commonwealth Government aged care costs are projected to grow strongly[17]

Component	2018-19	2019-20	2020-21	2021-22	2022-23	5-year Change
	Estimates ($m)			Projections ($m)		
Age Pension	46,741	48,301	50,265	52,285	54,766	**17.2%**
Aged Care	18,764	20,027	20,902	22,374	23,903	**27.4%**
Other Government expenses for the Aged	1,944	1,823	1,716	1,634	1,545	**(20.5%)**
Total	**67,449**	**70,151**	**72,884**	**76,293**	**80,215**	**18.9%**

Note: Figures for Age Pension costs are affected by the change in eligibility age which is increasing over this period.

For medical and health care costs, government meets nearly 70% of total costs across the whole population, health insurers meet nearly 10% of total costs, and individuals (net of private health insurance refunds) meet nearly 20% of total costs.[18] Significantly, the proportion of household expenditure net of any government rebates or health insurance refunds, steadily increases on these items with age (Graph 3).

Graph 3: Proportion of household expenditure on medical and health care



Source: Australian Bureau of Statistics, 2017

3.6 Changing work patterns

Work patterns, which have become more variable, also need to be supported by an integrated system of retirement provision. Women have increased their participation in the workforce at all ages, including returning to work after having children. Part-time employment across the whole population has doubled from 16% of the workforce to 32% over the last 40 years.[19] Potentially, if the 'gig economy' continues to grow, this development will further contribute to greater variability of work patterns and lower superannuation contributions for many gig workers. Job security also appears to have reduced for both full- and part-time workers in the past ten years.[20]

Many older workers are increasingly choosing to work longer with transition to retirement by engaging in part-time work.[21] Australia's part-time employment share of over 55s has more than tripled from just under 10% to 34% over the last 40 years.[22] Survey data indicates most people aged 45 years or older give personal preference as the reason for part-time work.[23] This is also reflected in the relatively low rates of under-employment for workers over 55.[24]

Greater variability in work, and therefore income, affects people's capacity to accumulate savings for retirement and how they begin the pension phase if they choose to transition to retirement by working part-time. In the case of those transitioning to retirement, they also need to navigate the interaction of superannuation and Age Pension systems.

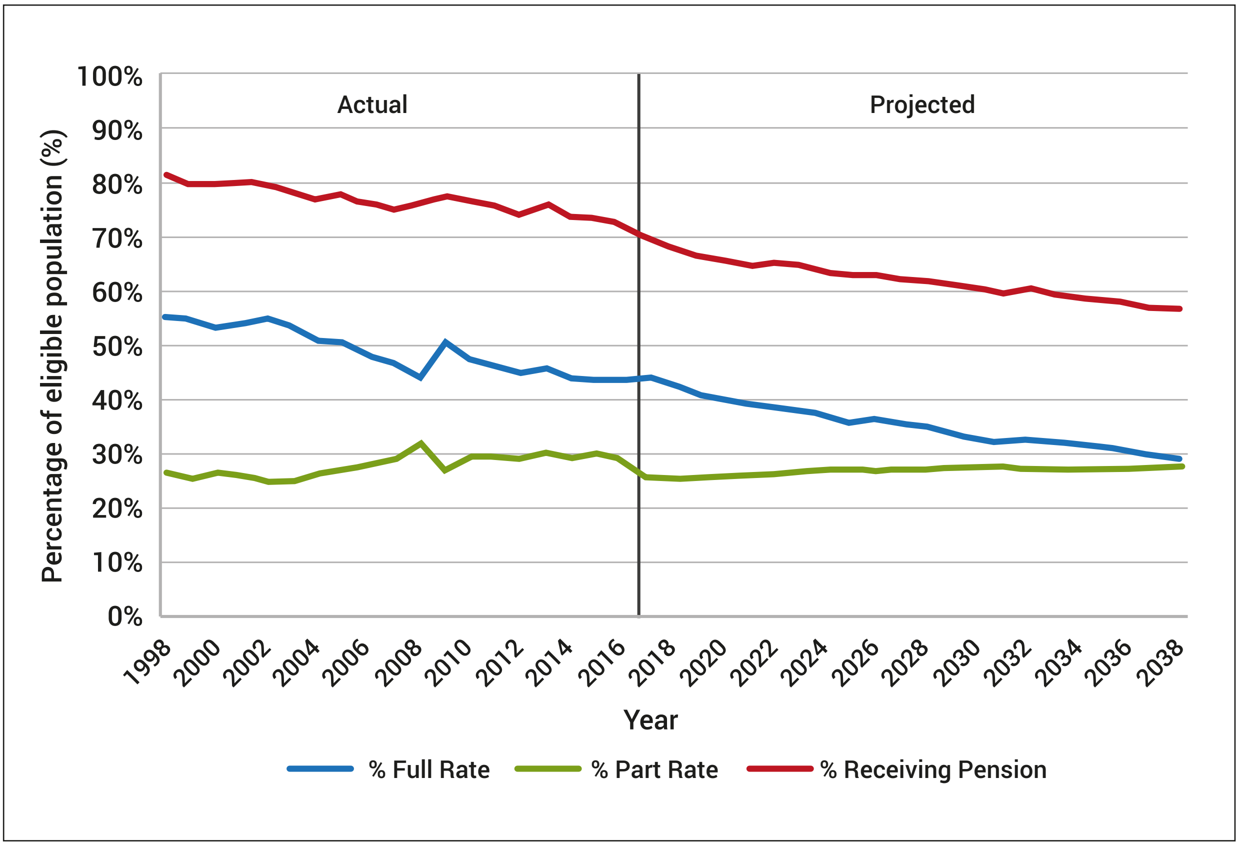
18 Actuaries Institute, 2019, p.12.
19 Australian Bureau of Statistics, 2019a.
20 Cassidy & Parsons, 2017, p.25
21 Australian Institute of Health and Welfare, 2015, p.229.
22 Australian Bureau of Statistics, 2019b, as a percentage of people in the labour force.
23 Cassidy & Parsons, 2017, p. 21.
24 Wilkins & Lass, 2018, p. 64.

3.7 Decreasing Age Pension dependency

Over coming decades, a smaller proportion of the aged population is expected to receive the Age Pension as income support. Through a combination of the maturing superannuation system (with people accumulating more superannuation assets over their life), the transition to an increasing Age Pension eligibility age and recent changes to Age Pension means tests, the projected proportion of the eligible population receiving the Age Pension will fall (Rice, 2018). Treasury findings support this (Roddan, 2018).

Graph 4 shows the proportion receiving a full Age Pension has reduced significantly over the last 20 years. The number of retirees not receiving any pension has also grown.

Graph 4: Proportion of the eligible population receiving the Age Pension



Source: Rice Warner

It also shows that the proportion of the eligible population receiving the Age Pension is projected to continue to fall from around 68% in 2018 to around 57% in 2038 assuming the SG increases to 12% as legislated. This fall is comprised of a significant fall in the proportion of the eligible population receiving the full rate of Age Pension (from 42% in 2018 to 29% in 2038) and a relatively smaller increase in the proportion of the population receiving a part-rate Age Pension (from around 25% in 2018 to 28% in 2038).

Notwithstanding the ageing population, Rice Warner's modelling shows there will be a decreasing reliance on the Age Pension, resulting in a modest fall in projected Age Pension expenditure from around 2.6% of GDP in 2018 to around 2.5% of GDP in 2038.

This projected decline contrasts with that provided in the first Intergenerational Report[25] which projected the cost of the Age Pension (and similar payments to veterans and war widows) to then grow from 2.9% of GDP in 2001-02 to 4.5% of GDP in 40 years (by 2041-42). The dramatic turnaround in projections is largely due to changes in the assets test and increasing superannuation balances at retirement.

One consequence of these trends is that more retirees will face greater complexity in retirement planning because they will be subject to the complex means tests. Another consequence is more retirees may therefore be very deliberate in how they structure their financial affairs to ensure they maximise their Age Pension entitlement, because the opportunity cost of not doing so is potentially high.

25 Commonwealth of Australia, 2002.

4 An international comparison

The Australian retirement income system ranked fourth out of 34 systems in the 2018 Melbourne Mercer Global Pension Index, or MMGPI (Mercer, 2018). This suggests the system is working well and the compulsory nature of the SG system is often cited as a pattern for others to follow. Yet even the MMGPI report notes that a B grade system (such as Australia's) "has a sound structure, with many good features, but has areas for improvement that differentiates it from an A-grade system".[26]

Table 2 highlights some of the differences between the top four countries in the MMGPI (the Netherlands, Denmark, Finland and Australia) and several countries like Australia (Canada, New Zealand, United Kingdom and the USA). It should be noted that the Australian superannuation system is very different from those in many countries and this is further discussed in Appendix B.

26 Mercer, 2018, p.6

Table 2: Comparison of pension systems

Country	Ranking	Overall score	Adequacy score	Sustainability score	Integrity score
	(out of 34)	(each out of 100)			
Netherlands	**1**	80.3	75.9	79.2	88.8
Denmark	**2**	80.2	77.5	81.8	82.2
Finland	**3**	74.5	75.3	61.0	92.1
Australia	**4**	**72.6**	**63.4**	**73.8**	**85.7**
New Zealand	**9**	68.5	65.4	63.4	80.6
Canada	**10**	68.0	72.1	56.0	78.2
Ireland	**12**	66.8	79.0	45.9	76.6
United Kingdom	**15**	62.5	57.8	53.4	82.9
USA	**19**	58.8	59.1	57.4	60.2

Source: Mercer, 2018

Despite ranking well on a global scale, Australia's retirement income system includes a number of weaknesses.

Although Australia ranks fourth, the table highlights our relative weakness in respect of adequacy. The primary cause of this result is the lack of an integrated approach between the different sources of retirement income.

Australia does relatively well in the following areas:

- a basic Age Pension worth about 28% of the average wage (which is higher than both the UK and USA) together with a means test free zone;
- good net pension replacement rates for low income earners due to the Age Pension and compulsory superannuation;
- a compulsory contribution rate of 9.5% (currently) for employees, although there is no compulsion for the self-employed;
- strong preservation of benefits until age 60 (in the future);
- a level of funded assets greater than 140% of GDP and growing; and
- a low cost of the Government-funded pension equal to less than 3% of GDP and reducing, as the superannuation system matures.

However, Australia does relatively poorly in the following areas:

- relatively low net pension replacement rates for the average income earner, even after a full career, due to the impact of the assets test in the early years of retirement[27] ;
- a complex means test system with both an income test and an assets test;
- an assets test taper that is, in effect, more than 100% of investment earnings and can therefore affect financial decisions made by retirees;
- a complicated taxation system for superannuation members and funds;
- a focus on unconstrained pension withdrawals (including 100% lump sum withdrawals at any time from age 60) rather than regular income streams which include drawing down of some capital during retirement; and
- a compulsory superannuation system that excludes those earning less than $450 per month and does not cover the self-employed.

27 The net pension replacement rate for an average income earner in Australia after a full time career is 42.6% (Male) and 38.8% (Female) as calculated by the OECD compared to the OECD average of 62.9% (Male) and 62.2% (Female). Higher net replacement rates occur at income levels below the full time average wage.

5 Options for reform

To start the conversation of what a system of integrated retirement provision could look like, the Institute sets out six broad areas where reforms seem desirable. The discussion in this section is intended to promote an informed and high-level debate of such a system by setting out considerations for potential options. The options are not exhaustive and the Institute welcomes feedback before it advocates any specific reforms.

The broad areas where reforms seem desirable are to:

- simplify the Age Pension, including its integration with superannuation and aged care;
- address the anomalies and perverse incentives from exempting the family home from Age Pension means testing;
- embed automatic adjustments to policy parameters in the Age Pension and superannuation systems to reflect changes in longevity over time;
- set targets for government expenditure for support in retirement;
- address taxation and aged care funding anomalies; and
- coordinate policies for support in retirement.

In each of these areas, there are various options to address some of the major shortcomings with the current arrangements. Each option represents an approach for an improved system of retirement provision, often in a more integrated way, which constructively responds to the long-term trends identified in Section 3.

Many of the options would require a sufficiently long transition period or other implementation arrangements to ensure that people approaching, or in, retirement do not have their plans significantly disrupted and become disadvantaged.

There are a number options to address major shortcomings with the current arrangements.

5.1 Simplify the Age Pension

There are three main reform options to simplify the Age Pension, each of which would improve the fairness and efficiency of the system.

Option 1: Simplify means tests

Underlying the current assets test is the strict principle that social security should not be paid to those with significant means. The approach that has been taken, however, is complex and makes it extremely difficult to plan for a stable income in retirement. The means-testing is also intrusive for retirees, with people resenting Centrelink frequently assessing their entitlement, and it adds to the administration and cost of the Age Pension system.

It would be possible to simplify or even eliminate the need for means-testing. Here are three ways.

Simplify by reducing the frequency of applying the assets test

A retiree could be tested at the time they reach Age Pension eligibility age. Based on their assets at that time, they could be given a full, part or no pension. This amount (if any) would then be indexed throughout retirement. While this method is simple, circumstances change in retirement and many people shift from part to full pensions as their superannuation capital is drawn down. It would therefore be necessary to review the situation periodically, say every three to five years, to ensure fairness as personal circumstances change. Retirees whose circumstances change adversely could ask for a review at any time.[28]

Eliminate by spending all or most wealth first

This option is that retirees would spend most of their superannuation benefit and any other wealth first and, once their assets then fall below a prescribed threshold, they would receive the full Age Pension. Part pensions would disappear. Behavioural finance suggests that many retirees would continue to be frugal and this would defer them receiving the Age Pension until later in retirement.

Buying the Age Pension

A variant of this is to require retirees to use a proportion of all their financial assets to 'buy' that proportion of the Age Pension to which they are not entitled, and then pay the full amount to everyone. For example, if the Age Pension is worth $800,000 for a couple[29] , then a couple with $1 million of assets at retirement would use $800,000 to buy a full Age Pension. Those with lower assets would have part-pensions, which would be topped up to full pensions, by a similar purchase at retirement. Those with few assets would have full pensions fully provided by the government (i.e. no purchase).

This would not be much more penal than currently but would be much easier for people to make sensible decisions with whatever assets remain. It would create a short-term cash flow bonus for government, which would need to be protected as Age Pension payments would increase in future (and be long term contingent liabilities).

28 Other complications which would need to be resolved include how to treat married couples (to reflect that they often do not retire at the same age) and what the payment amount should be indexed to (wages, CPI or something else).

29 The Age Pension is a material benefit for most Australians. The value received depends on the extent of the means testing and the discount rate applied to future payments. However, for a single person retiring at age 67 and entitled to a full Age Pension for life, the present value of the pension payments exceeds $500,000. The present value of the maximum Age Pension for a couple who retire at 67 today exceeds $800,000. The value of these benefits is much greater than the median retirement benefit paid from superannuation, which is about $300,000 for the current cohort of retiring Australians due to the relative immaturity of the SG system.

Option 2: Combine the assets and income tests into a single test

Combine the Age Pension means tests into one test

Australia is the only country in the MMGPI survey with both an assets test and an income test for the Age Pension.

The two means tests are confusing and complicated. They also make planning much more difficult for retirees. There is no need for a separate assets test. Deeming rules for all assets could allow for consistency between high and low yielding assets, and prevent gaming the system, so contributing to fairness and efficiency.

Of course, it is recognised there will be issues in establishing deeming rules for all types of assets and some age pensioners may suffer a loss of income while others could receive an increased pension. However, over the longer term, a single test will be simpler to understand and administer and could be established to encourage appropriate behaviour by all retirees.

Create one test for the Age Pension and aged care

As noted in section 3, aged care can be a significant cost to many older Australians. Currently, aged care is eligible for government funding subject to an assessment of need as well as means tests, including the Home Care Package for those who can and choose to stay in their own home, and residential aged care for those who move into a nursing home. Other aged care is not eligible for government funding including, for example, retirement villages.

The means tests for Age Pension and aged care are currently structured differently and the interaction is complex. For example, while there are income and assets tests for both, the thresholds and tapers differ. Further, while the value of the principal residence is exempt for the Age Pension, it is sometimes included up to a capped amount in the assets test for residential aged care. Creating a single income-based means test, across both the Age Pension and aged care, could improve achievement of the three principles outlined in section 2.

It would be possible to use the same rules to convert assets into income for both the Age Pension and for aged care. The contribution to aged care expenses can then be set at minimum of the actual costs and a percentage of the income. The percentage would have to differ between singles and couples and those with home care or in residential care.

- For those in home care, or where one member of a couple is in residential care, there would need to be a significant proportion of income exempt. This should at least be equal to the Age Pension.
- Single people in residential care could, however, pay a high proportion of all their income given they have limited other expenses.

Option 3: Introduce some universal benefits

One of the fundamental questions faced by all social security systems is the balance between universal and means-tested benefits. Providing benefits to all retirees above a certain age increases simplicity, provides greater confidence and reduces incentives to 'game' the system. However, inevitably, they are more expensive. On the other hand, means-testing benefits targets those who need the benefits at a lower cost to government but can encourage perverse behaviour and a misallocation of resources. Some countries provide a mix of

A single means test would be simpler to understand and administer, and encourage appropriate retiree behaviour.

universal and means-tested benefits whereas Australia has concentrated on means-tested benefits which has kept the cost of the Age Pension (expressed as a percentage of GDP) to a very low level, when compared to other OECD countries.

A universal minimum Age Pension

A full or part pension could be paid to all Australians above Age Pension eligibility age. New Zealand and the Netherlands pay the full pension on a universal basis whereas Denmark pays about half the pension universally with the balance subject to a means test.

For example, the current Age Pension could be divided into two components:

- a universal pension equal to 10% of the average wage; and
- an income-tested pension equal to the balance, namely 17.6% of the average wage.

A universal basic pension has broad appeal against many of the principles set out in Section 2. Its advantages include:

- The universal pension would include provision of the Pensioner Concession Care card, thereby removing the current incentive for many retirees to rearrange their affairs to receive a part pension and therefore the card. Such an outcome would encourage all retirees to maximise their assets and income.
- The introduction of the universal pension would improve the retirement income for the average income earner but would have a reduced effect at higher incomes as it would represent a fixed payment in dollar terms and would be taxable.
- As the income-tested pension would represent less than 18 per cent of the average wage, the income test would cease to have any effect where other income exceeded about 40 per cent of the average wage. This would provide a much clearer incentive for those with the capacity to save to do so, whereas such behaviour is not always immediately rewarded under the current system due to the assets test.
- The introduction of a universal part-pension may allow the taper rate on the income test to be increased from 50% to say 75% or even higher. This would bring it closer to the arrangements in many other countries which provide means-tested pension benefits. For example, the taper rate in Ireland, the UK and the USA is 100% in most cases which enable these benefits to be very tightly focused on the poor.
- The income test free zone and taper rate could ensure that full rate age pensioners would not be affected. The taper rate could be set to ensure that part pensioners receive a pension that is no less than they are currently receiving.
- The designs of the forthcoming CIPRs and any related requirements could be developed in the knowledge that all retirees will be receiving an Age Pension of at least 10% of the average wage. This should also lead to a stronger focus on incomes which will help promote the principle of financial security.

Of course, there would be an extra expense to the government budget from the increase in the number of part-pensioners. However, this expense would be offset, at least to some extent, by additional income tax from those with higher taxable incomes and, possibly, a reduced demand on government services due to the extra income and the changed behaviour as additional saving would be clearly rewarded. Moreover, this should be seen in the broader context that the government expenditure on pensions (when expressed as a percentage of GDP) is currently the fourth lowest of the 35 OECD countries[30] and less than half the OECD average with only Iceland, Korea and Mexico spending less than Australia. With the Australian expenditure projected to reduce as a per cent of GDP in future years, it is feasible that by 2050 the Australian expenditure will be the lowest in the OECD.

Equity could be further improved by making other adjustments in the tax system affecting high income earners only, thereby producing a more efficient retirement system, or including part of the home in the means test.

A more detailed discussion of this option is provided in Knox (2018).

A universal Pensioner Concession Card

Another reform option is that a Pensioner Concession Card (PCC) could be issued to all Australians above Age Pension eligibility age, even if they were not in receipt of any Age Pension. It would need to be rebadged as it would be universal. This would provide access to cheaper pharmaceuticals (for those listed on the Pharmaceuticals Benefits Scheme) and medical care (such as bulk billing). Dependent on the appetite and fiscal headroom for reform, access to discounts on other basic needs could also be included.

The key advantage of this reform is it would help achieve the principle of financial security as it would provide a base level of government coverage for the costs of aged care and pharmaceuticals. It would also contribute to the principle of efficiency as it would remove the incentive for retirees to 'game the system' to maximise government benefits (e.g. by retirees structuring their financial affairs to be eligible for government benefits such as the Pensioner Concession Card). It is also recognised that an extension of the PCC is likely to impose some additional costs on State and Territory Governments as well as some private enterprises.

5.2 Address the anomalies and perverse incentives from exempting the home

The current exemption of the principal residence from the Age Pension assets tests works against the fairness and efficiency principles set out in Section 2. These distortions have become increasingly pronounced in recent decades. Up until about 30 years ago, the value of a principal residence in a capital city was about 2.5 times average annual earnings. It has grown to between 8 and 12-times earnings varying by State/Territory[31]. Consequently, the principal residence is a valuable investment, far beyond what was originally envisaged for social security purposes.

Option 1: Recalibrate the difference between renters and owners

Non-homeowners are insufficiently compensated for the different income earning capacity of their assets relative to their expenses.[32] Single retirees in private rental accommodation in capital cities are particularly affected because rents are high, yet Rental Assistance is nationally uniform.[33]

An illustrative reform would be to double the current difference of the assets test thresholds between non-homeowners and homeowners and allowing for this increased difference to flow through to their income test threshold.[34]

30 Organisation for Economic Co-operation and Development, 2017, Table 7.5.

31 House prices have been falling and may settle at 6-to-9 times earnings, which is still significantly higher than past values.

32 The Age Pension assets test threshold for non-homeowners is $207,000 higher than for homeowners yet the average value of the principal residence is far in excess of that. To be equitable, the difference in the minimum thresholds should be more representative of the value of a pensioner's home.

33 It is notable that 95% of homeowner couples are projected to be on retirement incomes of at least the ASFA modest level, compared to only 28% for renting couples. Single female private renters are projected to have the lowest levels of retirement income adequacy, with only 23% expected to achieve the ASFA modest level, compared to 35% for single male renters.

34 Under current policy settings this would increase the assets test threshold for non-home owners from the current $465,500 to $672,500 for singles and from the current $594,500 to $801,500 for couples.

Actual rental payments are significantly higher than the level of Centrelink Rental Assistance, with the maximum Centrelink Rental Assistance being $137.20 per fortnight for a single renter living alone whereas the median rent is closer to $400 per fortnight. CEPAR research indicates Commonwealth Rental Assistance has fallen from about 25% of average market rentals to 16% since 2001.[35]

The Institute makes no detailed calculations as to precisely what would be fair but suggests that the amount should be approximately doubled. While $7,000 p.a. is not enough to fully cover rent, homeowners face significant costs that would have to be considered in detailed modelling. Doubling rent assistance to pensioners would cost less than $1 billion, but much of this would be recovered by social housing providers so the net cost is less. It is unlikely to exceed 0.5% of the cost of support to the aged, although the non-pensioners would also need to be considered, which would increase the costs significantly.

There is also a need to ensure fairness between those on Rental Assistance who are in social housing and those who are not, and to recognise that there are people of working age receiving Rental Assistance.

Option 2: Include all or part of the home in assets

The exemption of the principal residence from the assets test also discourages homeowners from downsizing as the proceeds of doing so would become subject to means testing. This results in an inefficient allocation of the national housing stock. Some retirees are therefore foregoing what would otherwise be an optimal decision to free up capital from their principal residence to provide additional income.

The exemption also creates anomalies between different homeowners. For example, a couple with a home worth $500,000 and financial assets of $853,000 or more would receive no Age Pension. In contrast, a couple with a home worth $3 million and up to $387,500 in financial assets would receive a full Age Pension. A further discussion of these perverse effects and options is provided in Rice (2018) and Asher and De Ravin (2018).

The need to include the value of the principal residence in the means tests, whether in its entirety or above a threshold, has been recommended by many reviews, including the Harmer Pension Review (Harmer, 2009), the Henry Taxation Review (Treasury, 2008) and three times by the Productivity Commission (2011, 2013 and 2015).

If there is a single (income) means test, a rent could be imputed for the value of the principal residence above a threshold.[36] What that threshold amount is set at requires a trade-off between maximising incentives for retirees to 'right size' their home, the administrative costs of more retirees being impacted by the income test and equity considerations.

Applying a uniform threshold across the country would penalise those in areas where houses, and often the cost of living, is higher. To address this possibility, one might set the threshold relative to the average house price in the post code in which the retiree is resident.

For those who did not want to downsize, the Pension Loans Scheme (PLS) or an equivalent would provide a mechanism for retirees to manage the change. It is important that such schemes guarantee that pensioners are never evicted even if the amount of the loan exceeds the value of the house.

35 Chomik, Graham, Yan, Bateman & Pigott, 2018a, p.29.

36 Given housing prices vary significantly by geographic location, consideration could be given to whether the threshold amount should vary by location. However, administering such variable thresholds could add excessive complexity to the system. Also, movement is to be encouraged if it enables retirees to achieve a higher standard of living.

5.3 Embed automatic adjustments to reflect changes in life expectancy

There are two obvious reforms to ensure an integrated system of retirement provision can adapt to the long-term trend of changes in life expectancy. Further consideration, beyond the high level ideas outlined below, should also be given to how the growing diversity in life expectancy across different socioeconomic backgrounds can be incorporated into policy settings.

Option 1: Reduce the gap between superannuation preservation age and Age Pension eligibility age to reflect changes in life expectancy

Preservation age is the age at which a person can access their superannuation if they are retired or have commenced a transition to retirement. Preservation age is currently between 55 and 60 years, depending on when the person was born. By 2024, the preservation age will be 60 years for everyone. Like the Age Pension eligibility age, there has been a gradual increase in the preservation age recognising the change in life expectancy and fiscal considerations.

Currently, by 2024 there will be a seven-year gap between the preservation age and the Age Pension eligibility age. During this time, dependent on a person's investment strategies, their superannuation balances could be extinguished or significantly reduced if they are retired or drew down the maximum benefits available under transition to retirement rules (10% per year). This increases the likelihood of their calling on a full or part Age Pension from eligibility age.

It is important to consider whether such a future fulfils the objective of the superannuation system to "provide income in retirement to substitute or supplement the Age Pension" as suggested by the Financial System Inquiry (Commonwealth of Australia, 2014).

An option worthy of consideration is maintaining a fixed gap between the Age Pension eligibility age and the superannuation preservation age, such as five years. Such an option balances the objective of superannuation substituting or supplementing the Age Pension with the fact that the superannuation benefit belongs to the individual, at least partly from wages they have forgone albeit in return for a tax concession.[37]

The superannuation preservation age will become an increasingly important behavioural age for retirement planning as the SG system matures - superannuation will become the predominant source of retirement income for most people and rules around its access will therefore heavily influence retirement planning.

Whatever fixed gap is chosen should also flow through to the Centrelink rules around gifting – specifically, all gifting between superannuation preservation age and Age Pension eligibility age should be subject to gifting rules to ensure the principle of fairness. Currently, the gifting rules apply over a five-year rolling period (as well as an annual limit) which is a shorter period than the period between the preservation age and the pension eligibility age.

Continuing to allow access to superannuation from an age below the Age Pension eligibility age may provide these people with greater dignity than the alternative of accessing pre-retirement income support, such as the Disability Support Pension. There would also be fiscal benefits, at least in the short term, for the government and taxpayers.

37 Superannuation balances would wholly represent wages foregone if all SG contribution payments made by the employer have been at the opportunity cost of higher wages.

It is important to recognise that some people will retire before Age Pension age through an inability to sustain the demands of working, a lack of paid employment opportunities and/or because they have become unpaid carers for elderly or young relatives. The current capacity for people to apply for and obtain disability and carer pensions as well as to access their superannuation before preservation age, on compassionate grounds, should continue. This will also help provide dignity.

As a general principle, the superannuation preservation age should be revisited every five years with either the release of updated Australian Government Actuary Life Tables or the subsequent Intergenerational Report.

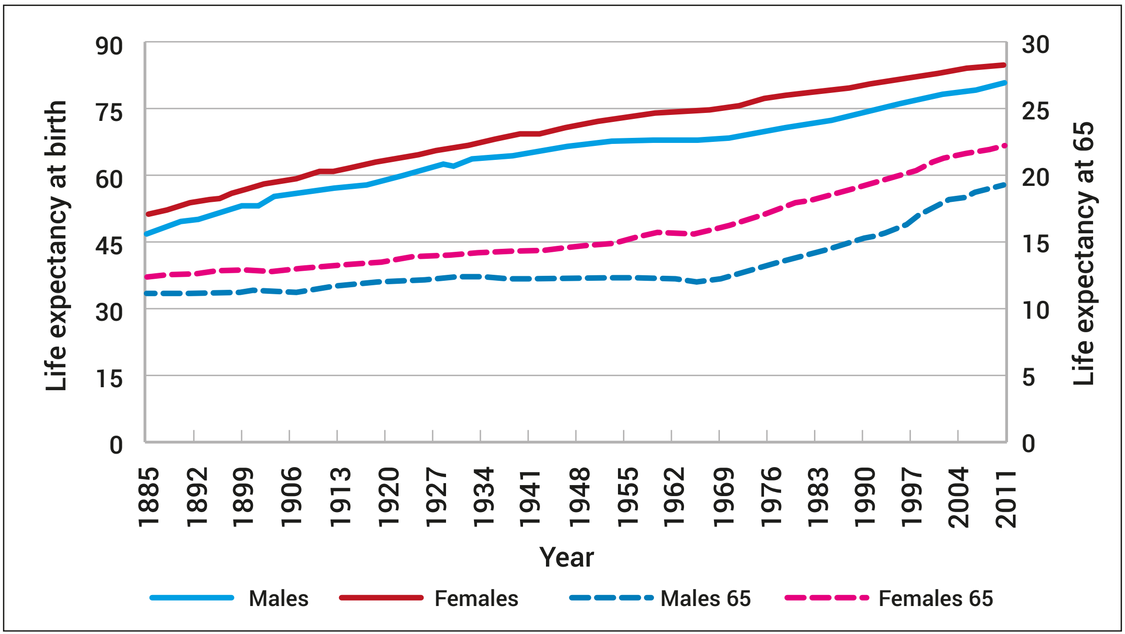
Option 2: Change Age Pension eligibility age to reflect changes in life expectancy

When the Age Pension was first established at the Commonwealth level in 1909, the eligibility age for males was 65 years. Then, average male life expectancy at birth was 55 years and average life expectancy at Age Pension eligibility age was 76 years (the corresponding figures for females were 59 and 78 years respectively). The average retirement period funded by the Age Pension was therefore 12 years, but most people were not expected to reach pension eligibility age. This meant the cost was affordable.

The current age at which people can apply for the Age Pension is between 65 and 67 years, dependent on when they were born. By 2023, the eligibility age will be 67 years for all people. Male life expectancy at birth is now 80 years and average life expectancy at Age Pension eligibility age is about 84 years (the corresponding figures for females are about 84 and 87 years respectively). The average retirement period funded by the Age Pension now is therefore close to 20 years and the average person is expected to reach pension eligibility age.

Graph 5 shows the growth in life expectancy at birth and age 65 according to Australian Life Tables. The growth in life expectancy at age 65 is particularly marked since the 1970s.

Graph 5: Australian life expectancies at birth and at age 65 (years)



Source: Australian Government Actuary, 2014, pp.44-45

To date the upwards cost pressures from increased longevity and maintaining the Age Pension by indexation to wages has been more than offset by the effect of increased superannuation balances and changes to Age Pension means-testing as outlined in Section 3.7. Looking ahead, and absent any additional Age Pension changes, the average period funded by the Age Pension and the proportion of the population living to and beyond that age will further increase.

A reform which would improve the sustainability of the system is linking changes in the Age Pension eligibility age with changes in life expectancy, such as those determined and published every five years by the Australian Government Actuary. Linking the two ages would also provide greater certainty to the public as changes in the Age Pension eligibility age would be determined objectively.

The Institute is conscious that there is not widespread community support for further increases in the Age Pension eligibility age, as evidenced by the discussion around the September 2018 Government policy decision to not proceed with the then planned further increased in Age Pension eligibility age to 70 years. A common concern raised is around the capacity of some workers to be able to sustain employment to that age.

Recognising this, the linkage between improvements in life expectancy and Age Pension eligibility age need not be one-for-one. The linkage could, for example, be that for every year life expectancy increases, there is a six month increase in the Age Pension eligibility age.[38]

Another consideration will be ensuring enough meaningful employment opportunities exist at increasing ages. Part of the solution could lie in society explicitly valuing and rewarding work undertaken by older Australians, for example community services. This is an important future labour market issue which is beyond the scope of this paper but inextricably linked to the feasibility of this option.

As mentioned above, people who cannot find or sustain enough employment before they reach Age Pension eligibility age, should continue to be entitled to other social security, such as the Disability Support Pension, and their superannuation.

5.4 Set a target for government expenditure

At the time of the last Intergenerational Report[39], government expenditure on aged care was projected to increase from 0.9% of GDP in 2014-15 to 1.7% of GDP by 2054-55. As longevity and the costs of providing care to the elderly continue to increase, perhaps the fiscal headroom provided by the projected reduction in Age Pension expenditure noted in Section 3.7 should be used to fund the provision of aged care services. The adequate provision of aged care for retirees will certainly ensure that retirees are afforded dignity in the later stages of their life.

It is worthwhile considering whether there should be a medium-term target for combined Age Pension and aged care expenditure, as a subset of the government's medium-term fiscal policy objective. If there was a goal of paying (say) 4.0 to 4.5% of GDP for these benefits, or higher dependent on fiscal headroom, it would then be the role of government to ensure that the payments were made equitably.

38 A practical solution would also need to be found for the fact that improvements in male and female life expectancy are unlikely to always be the same.

39 Commonwealth of Australia, 2015

This approach should not equate to short-term volatility in individuals' Age Pension and aged care payments and any such target would need to be framed appropriately to guard against such an outcome (for example, it could be framed in terms of 'over the course of the economic cycle'). A medium-term target could provide greater certainty to retirees and the aged care and related sectors for retirement planning, supporting the principles of financial security and efficiency.

5.5 Address taxation and funding anomalies

While most of the taxation questions are ongoing political issues, there are some anomalies that the Institute believes need consideration in the short term. It also worth reconsidering the right to request Refundable Accommodation Deposits (RADS) as a form of funding for aged care.

Option 1: Perceived unfairness

Public support for the superannuation system is undermined by the existence of generous tax concessions to wealthy individuals with unusually large superannuation balances. It is well known that there are individual accounts worth tens of millions of dollars that are being taxed at the concessional rates for all superannuation of 15% on investment income and 10% on capital gains. The tax concessions on the investment income from such large balances seems to be an unintended consequence of the rules, and it would be reasonable to remove them.

This could be achieved either by capping the amount that can be kept within the superannuation system, or by requiring those with unusually large balances to pay additional tax. The existence of the $1.6 million cap on post-retirement balances provides a precedent for a cap based on account size.

Option 2: End-of-life issues

While the prime purpose of superannuation is to provide retirement incomes, it is also used for other purposes. Australia is far more flexible in allowing benefits to be used for other purposes. For example, there is no limit on the amount of lump sums which can be drawn at the time of retirement or at any time thereafter. This is helpful for retirees who can leave a nest egg within their pension, accumulating tax-free. However, it does allow wealthier Australians to hold large benefits which they can leave as a bequest later in life. While death benefits are taxed at 17% if left to non-dependants, retirees who are in declining health can transfer their benefit out tax-free before they die.

As balances have grown, commentators have questioned whether this is a fair use of tax concessions, given such bequests effectively leak from the system. To improve fairness, and inter- and intra- generational equity, it is apparent there should be limitations around bequests and gifting.

When a retiree dies, the benefit is paid tax-free to their spouse (or in a few cases to another dependant). For those without any dependants, the benefit is taxed at 17% (including Medicare Levy). However, the majority of retirees pass away with some early warning. Thus, it is possible to draw the entire benefit out tax-free before death. In some cases, middle-aged children will benefit from a tax-free superannuation benefit and a tax-free home (since we have no death duties nor capital gains tax on a family home).

It would be desirable to have consistency on death benefits. One option is to reintroduce a maximum annual lump sum withdrawal to prevent people drawing out the whole benefit; another is to tax all death benefits equally irrespective of the status of the beneficiaries.

The other weakness of having unlimited lump sums is that it is possible to gift benefits, usually to other family members. These amounts are recorded by Centrelink and are maintained as 'assets' for means testing purposes for five years. The limited duration on this 'gifting' can be exploited as noted in section 5.3. It is possible to draw tax-free benefits at any time from age 60 and give the benefits away. As the eligibility age for the Age Pension is closing in on age 67, it is possible to draw enough money out between ages 60 and 62, which will increase the Age Pension entitlement later.

In summary, consideration should be given to some form of universal death duty.

Option 3: Phase out the right to request Refundable Accommodation Deposits in aged care

The Refundable Accommodation Deposits (RADs) that can currently be used to fund aged care are undesirable from the perspective of the residents. Their existence creates anxiety in that retirees become concerned that they might need to find significant lump sums at short notice. This also contributes to a reluctance to invest in life annuities or pensions. Whether to withdraw a lump from superannuation is a stressful and complex decision because it cannot be recontributed later.

It is also debatable whether RADs are in the best long-term interests of aged care providers. Arguably, providers should not be funding long term property assets with short term loans from particularly vulnerable residents. To the extent that debt is required, long term investments should be funded by long term loans from informed lenders who would impose appropriate financial standards on the borrowers.

A reform option is whether the right to request RADs should be phased out as soon as practicable.

5.6 Coordinate policy for support in retirement

The lack of coordination of government policy could be addressed in a few ways.

Option 1: Legislate objectives for the retirement system

Coordination could be facilitated by legislation that sets out the objectives of each element of the retirement system and the principles for integration between them. Such principles could lead to the reform examples included in this Paper of a unified means test for the Age Pension and aged care and rules for approaching the questions of inter-generational and intra-generational equity.

Option 2: Set up a coordinating body

A more flexible approach would be to ensure coordination of policy development by setting up an inter-agency group to make recommendations to government. It should have a wide remit to address structural issues as well as changes in parameters. This body should include representation from the departments of Aged Care, Australian Government Actuary, Health, Social Services, Treasury and Veterans' Affairs.

Option 3: Calibrate social security benefits and living standards across the lifespan

An alternative or complementary approach to these options would be that the government sets a minimum standard of living for all Australians that enables everyone to live with dignity, and that the Age Pension and aged care benefits be set at a level that makes this possible. The minimum standard of living could be defined, for example, by reference to financial deprivation measures or as a per cent of GDP.

The minimum standard should include access to adequate housing and utilities, food and clothing with a focus on avoiding financial stress or financial deprivation. This standard would be set with reference to community expectations of minimum living standards relative to the rest of society. This can alternatively be phrased as 'affordability'.

The minimum standard would need to be calibrated to overall standards of living and other social security benefits. This would require a reliable survey of the expenditure of vulnerable and lower income groups to ensure they were not prejudiced by the operation of the system. A current indicator available is the Australian Bureau of Statistics Household Expenditure Survey.

5.7 Refining the reform options

The Institute encourages robust debate around the proposals set out in this paper, and more generally, to ensure the public policy framework underpinning Australia's retirement system is strong and fit for the foreseeable future. As part of this process the Institute welcomes contributions. Contributions can be emailed to actuaries@actuaries.asn.au.

Appendices

Appendix A
Objectives of Australia's retirement income system

We see the role of the retirement system is to provide for appropriate financial resources in retirement. This includes an income adequate to provide not only for basic needs, but also maintain a standard of living for the majority of Australians[40] comparable with that they enjoyed while working, and with members of their families and communities[41]. It also provides for contingencies, particularly insurance arrangements to cover health and aged care costs.

The sources of income available to meet this objective include:

- the taxpayer funded Age Pension and related benefits provided by the Government;
- compulsory superannuation from the retiree's employment;
- additional superannuation arising from voluntary contributions by the individual;
- employment income, including part time and casual work;
- additional savings and investments outside superannuation;
- income generated from a loan backed by the retiree's main residence; and
- insurance protecting risks such as longevity, health and aged care.

These sources of retirement income should be complementary so there are limited reasons for individuals and households to engage in unproductive manipulation of their assets and income to access government resources. Self-reliance for retirement has its own merit as well as reducing fiscal pressures. From an intergenerational perspective, it is important that the costs of the Age Pension and taxation support for superannuation are sustainable over the longer term.

It is also critical that the purposes or objectives of the main three sources of income (or pillars – the Age Pension, compulsory superannuation and voluntary savings in- and out-side of superannuation) are clear and well understood by the community.

The objective of the Age Pension (or safety net) is to provide a modest level of income to those who have attained a certain age and do not have a sufficient level of financial resources to provide a minimum standard of living during their retirement years. That is, the level of the pension and the related benefits should ensure no older Australian lives in poverty. The operation of the means tests represents an important policy in determining the distribution of the pension as well as its relationship with superannuation and other savings.

The objective of compulsory superannuation is to ensure that all working Australians set aside a proportion of their current income for retirement. Over a full working career, compulsory superannuation contributions should be sufficient to provide a level of retirement income, together with any Age Pension, that enables a living standard to be maintained throughout retirement that is no greater than their 'average living standard' during most of their working years when contributions were made. Consideration could be given to a default level of contribution in excess of the compulsory level to bring living standards to a level equal to the 'average living standard.'

The objective of voluntary superannuation is to provide flexibility for individuals to make additional contributions (as may be appropriate) that can improve their retirement lifestyle and thereby offset any shortcomings in their compulsory superannuation benefit. These could arise for several reasons including periods out of the workforce, improvements in community living standards, increases in longevity and adverse market movements.

---

40 This objective deliberately uses the term "the majority of Australians" and not "all Australians" as the objective should not be concerned with the maintenance of lavish or expensive lifestyles.

41 The objective to maintain living standards in retirement may not be directly related to the income earned in the years preceding retirement or the attainment of a certain level of savings (inside or outside superannuation). It is more complicated than that and we need to recognise the variety of personal circumstances. For example, incomes may drop some years before retirement whereas in other cases individuals may continue to work past the Age Pension eligibility age.

Appendix B
International comparison of Australia's superannuation system with the rest of the world

Australia's superannuation system is very different from those in many other countries.

Firstly, it is compulsory for employers to contribute in respect of almost all their employees. A failure in the initial design made it difficult for members to consolidate their accounts when moving employers and led to many unnecessary and uneconomic accounts. This has been, and will continue to be, addressed.

Second, Australia moved from defined benefit (DB) to defined contribution (DC) schemes before most other countries. Australian DC schemes also offer considerable investment choice. While on average this can lead to better benefits for the same contributions, it shifts risks to members who need to understand and manage them. The Productivity Commission suggests that, "The substantial proliferation of investment options in the choice segment (some 40 000) complicates decision making and increases member fees, without boosting net returns."[42] There are therefore greater needs for member engagement and education, and for appropriate disclosure requirements.

Third, Australia has had a lump sum approach to the provision of retirement benefits that predates compulsory superannuation. While this may have been initially prompted by taxation considerations, it has meant than Australian retirees have considerable choice and responsibility at and during retirement compared to most other countries where a pension is paid.

It is often suggested that Australia has a relatively expensive superannuation (or private pension) system when compared with the rest of the world. However, there are some important differences within the Australian system when compared to the systems in many other developed economies. These include:

- There are relatively higher administration costs in the accumulation phase compared to the pension phase. The reason is simple. During the accumulation years, the system is dealing with a range of transactions (including a range of contribution types and changing employers) and member balances can be relatively low compared to the pension phase when balances are higher and the administration is much simpler (i.e. a pension is being paid). Hence, where the system is still maturing (as in Australia), the relative costs (when expressed as a percentage of assets) would be expected to be higher. In addition, the investment costs tend to be lower in the pension phase due to more conservative investments.
- Generally, DC arrangements are costlier due to individual accounts and investment choice as occurs in Australia. By contrast, DB funds normally have a single pool of assets, limited individual records and almost no member choice. Australia, with its predominantly DC system, would therefore be expected to have a higher level of costs than a predominantly DB system as occurs in many European countries and Canada.
- The presence of Self-Managed Superannuation Funds (SMSFs) in Australia inevitably affects the structure and costs of the Australian superannuation industry. This occurs in several ways including:
  - The transfer of members with significant accounts to the SMSF sector reduces the average size of member accounts within the APRA-regulated fund sector and therefore increases the costs for these funds.
  - The need for funds to compete directly with the SMSF sector through the provision of additional services (e.g. member directed share portfolios and additional information) increases costs.
  - The continuation of small accounts within the APRA-regulated fund sector where individuals continue to hold member accounts to obtain cheaper insurance whilst transferring most assets to their SMSF.
- Investment strategies have implications for underlying investment costs. When compared to many pension

42 Productivity Commission, 2018, p 48.

systems around the world, the Australian system has a much higher exposure to equities, property, infrastructure and unlisted assets. Such assets have a greater cost than investments in fixed interest and cash but normally deliver better returns over the longer term.

- The taxation of superannuation in Australia includes taxation on contributions, investment income and some benefits (concessionally taxed-concessionally taxed-mostly exempt, or tte). This means that superannuation funds are required to administer the complexity of the taxation rules with different rules applying to different types of contributions, different rates applying to investment income in the accumulation and pension phases, and different rules applying to different types of benefits. In short, it is extraordinarily complex and costly to administer. On the other hand, many countries adopt an Exempt-Exempt-Taxed (EET) system of pension taxation where the contributions and investment income are exempt from taxation whilst the benefits are taxed when received by the individual. This extra administration relating to taxation at all stages in Australia adds significant costs to industry.
- With compulsory superannuation, Australia has a strong regulatory environment for good reason. However, the existence of strong regulators adds additional costs to the system through both the levies paid to meet the regulators' costs as well as the significant compliance costs that occur when there are strong and active regulators. The regulatory environment has also undergone continuous change for three decades. The combination of these costs is much higher than in many countries.
- The compulsory requirement to provide death and disablement benefits in all MySuper products means there are additional administration costs incurred by superannuation funds as they design an appropriate insurance policy/ies, negotiate with the insurer, communicate with members and manage a range of claims from members. It should be noted that many other systems have no insurance requirements.
- The system includes significant distribution (selling) costs in respect of the self-employed who are not covered by the SG system. There are also costs in persuading or advising members to make additional contributions. A considerable proportion of contributions (over a third) are voluntary from these two sources.
- Finally, most superannuation funds offer members intra-fund or scaled financial advice. This is greatly appreciated by many members as decisions are needed to be made in respect of investment choice, insurance and retirement. However, inevitably such a service, which is often not provided by pension funds in other countries, adds additional costs to superannuation.

References

Actuaries Institute. (2015). *For Richer, For Poorer: Retirement Incomes – White Paper.* Retrieved from: https://www.actuaries.asn.au/Library/Opinion/2015/ForRicherForPoorerRetirementIncomes2WEB.pdf

Actuaries Institute. (2019). *How to make private health insurance healthier* – Green Paper. Retrieved from: https://actuaries.asn.au/Library/Opinion/2019/GPHEALTIERPHI2019WEB1.pdf

Australian Bureau of Statistics. (Various dates). *Life Tables, States, Territories and Australia* (Cat. No. 3302.0.55.001). Retrieved from: http://www.abs.gov.au/AUSSTATS/abs@.nsf/Lookup/3302.0.55.001Main+Features12015-2017?OpenDocument

Australian Bureau of Statistics. (2017). *Household Expenditure Survey, Australia: Summary of Results, 2015-16* (Cat. No. 6530.0). Retrieved from: https://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/6530.02015-16?OpenDocument#Data

Australian Bureau of Statistics. (2019a). *Labour Force, Australia* (Cat. No. 6202.0). Retrieved from: http://www.abs.gov.au/ausstats/abs@.nsf/mf/6202.0

Australian Bureau of Statistics. (2019b). *Labour Force, Australia, Detailed – Electronic Delivery* (Cat. No. 6291.0.55.001). Retrieved from: https://www.abs.gov.au/ausstats/abs@.nsf/0/16CF9AD7C2477BA5CA257F630014C8C0?Opendocument

Australian Government Actuary. (2014). *Australian Life Tables 2010-12*. Retrieved from: http://www.aga.gov.au/publications/life_table_2010-12/downloads/Australian_Life_Tables_2010-12_Final_V2.pdf

Australian Institute of Health and Welfare. (2014). *Healthy life expectancy in Australia: patterns and trends 1998 to 2012 – Bulletin 126*. Retrieved from: https://www.aihw.gov.au/getmedia/574217b8-c1a8-4d83-b49f-02a764f6f9a4/18281.pdf.aspx?inline=true

Australian Institute of Health and Welfare. (2015). *Australia's Welfare 2015*. Retrieved from: https://www.aihw.gov.au/getmedia/692fd1d4-0e81-41da-82af-be623a4e00ae/18960-aw15.pdf.aspx?inline=true

Cassidy, N. & Parsons, S. (2017). *The Rising Share of Part-time Employment. Reserve Bank of Australia Bulletin*, September Quarter, 19-26.

Chomik, R., Graham, S., Yan, S., Bateman, H., & Piggott, J. (2018a). *Retirement income in Australia: Part II – Public support*. Retrieved from: http://cepar.edu.au/resources-videos/research-briefs/retirement-income-australia-part-2

Chomik, R., Graham, S., Yan, S., Bateman, H., & Piggott, J. (2018b). *Retirement income in Australia: Part III – Private resources.* Retrieved from: http://cepar.edu.au/resources-videos/research-briefs/retirement-income-australia-part-3

Chomik, R. & Townley, C. (2019). CEPAR *Fact Sheet: Aged Care Policy, Provision, and Prospects.* Retrieved from: http://cepar.edu.au/sites/default/files/cepar-fact-sheet-aged-care-policy-provision-prospects.pdf

Commonwealth of Australia. (2002). *Intergenerational Report 2002-03*. Retrieved from: https://treasury.gov.au/publication/2002-igr

Commonwealth of Australia. (2014). *Financial System Inquiry – Final Report.* Retrieved from: http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf

Commonwealth of Australia. (2019). *Budget Strategy and Outlook, Budget Paper No. 1, 2019-20.* Canberra, Australia: Author.

Commonwealth of Australia. (2019). *Final Report – Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.* Retrieved from: https://financialservices.royalcommission.gov.au/Pages/reports.aspx

Cullen, D. (2019.) *Medium- and Long-Term Pressures on the System: The Changing Demographics and Dynamics of Aged Care – Background Paper 2 for the Royal Commission into Aged Care Quality and Safety*. Retrieved from: https://agedcare.royalcommission.gov.au/publications/Documents/background-paper-2.pdf

References (continued)

De Ravin, J. and Asher, A. (2018). *The Age Pension means test: contorting Australian retirement.* Retrieved from: https://actuaries.asn.au/microsites/financial-services-forum-2018/program/papers-and-pre-reading

Harmer, J. (2009). *Pension Review Report*. Retrieved from: https://www.dss.gov.au/sites/default/files/documents/05_2012/pensionreviewreport.pdf

Knox, D. (2018). *Retirement Incomes – Australia vs the Rest of the World.* Retrieved from: https://actuaries.asn.au/microsites/financial-services-forum-2018/program/papers-and-pre-reading

Mercer. (2018). *Melbourne Mercer Global Pension Index.* Australian Centre for Financial Studies, Melbourne.

Ong, R. & Wood, G. (2019, June 12). More people are retiring with high mortgage debts. The implications are huge. *The Conversation*, Retrieved from https://theconversation.com/more-people-are-retiring-with-high-mortgage-debts-the-implications-are-huge-115134

Organisation for Economic Co-operation and Development. (2017). *Pensions at a Glance 2017: OECD and G20 Indicators*, OECD Publishing, Paris.

Parliamentary Budget Office. (2018). *2018-19 Budget: Medium-term projections*. Retrieved from: https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Budget_Office/Publications/Research_reports/Medium-term_budget_projections

Productivity Commission. (2011). *Caring for Older Australians*, Report no. 53, Canberra.

Productivity Commission. (2013). *An Ageing Australia: Preparing for the Future*, Commission Research Paper, Canberra.

Productivity Commission. (2015). *Housing Decisions of Older Australians*, Commission Research Paper, Canberra.

Productivity Commission. (2018). *Superannuation: Assessing Efficiency and Competitiveness – Productivity Commission Draft Report: Overview*. Retrieved from: https://www.pc.gov.au/__data/assets/pdf_file/0014/228200/superannuation-assessment-draft-overview.pdf

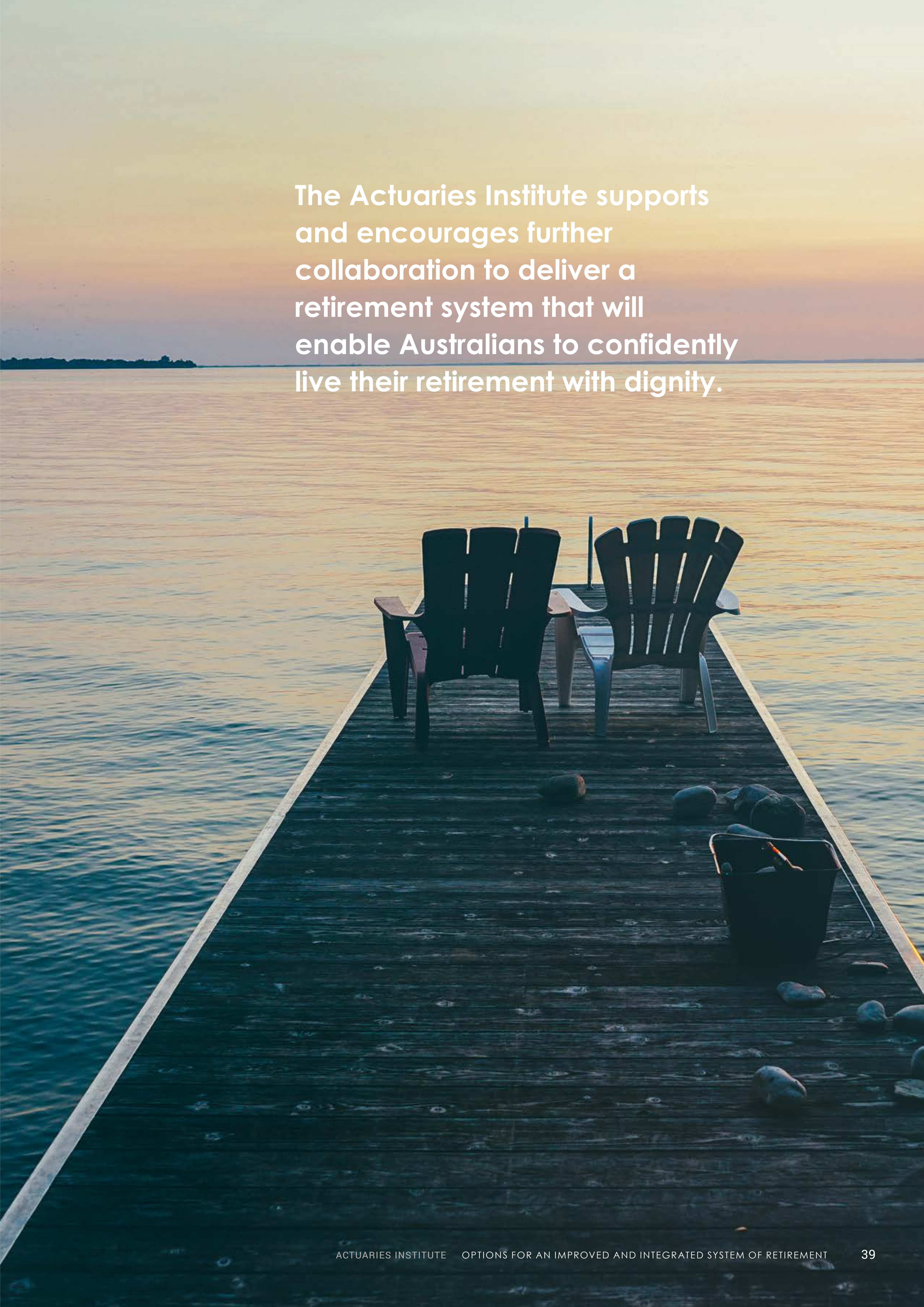
Rice, M. (2018). *The Age Pension in the 21st Century*. Retrieved from: https://actuaries.asn.au/microsites/financial-services-forum-2018/program/papers-and-pre-reading

Roddan, M. (2018). Age Pension liability 'will fall faster than projected'. *The Australian*. Retrieved from: https://www.theaustralian.com.au/national-affairs/treasury/age-pension-liability-will-fall-faster-than-projected/news-story/bbc2f880752988bb86592fccf3ca060e

Treasury. (2008). A*ustralia's future tax system – Report to the Treasurer*. Retrieved from: http://taxreview.treasury.gov.au/content/downloads/final_report_part_1/00_AFTS_final_report_consolidated.pdf

Tune, D. (2017). *Legislated Review of Aged Care.* Retrieved from: https://agedcare.health.gov.au/sites/default/files/documents/08_2017/legislated_review_of_aged_care_2017.pdf

Wilkins, R. & Lass, I. (2018). *The Household, Income and Labour Dynamics in Australia Survey: Selected Findings from Waves 1 to 16*. Melbourne Institute: Applied Economic & Social Research, University of Melbourne.



The Actuaries Institute supports and encourages further collaboration to deliver a retirement system that will enable Australians to confidently live their retirement with dignity.

Institute of Actuaries of Australia
ABN 69 000 423 6546

Level 2, 50 Carrington Street
Sydney NSW Australia 2000
t +61 (0) 2 9239 6100
f +61 (0) 2 9239 6170
e actuaries@actuaries.asn.au
w www.actuaries.asn.au