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# Means Tests: an evaluation of the justice of imposing high rates of clawback on those of modest means

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## Abstract

Integration between flat state pensions, which make up the first pillar of a pension system, and other sources of retirement income is achieved in many countries<sup>1</sup> by means tests that reduce the first-pillar pension. It is currently the subject of some debate in the UK and South Africa, and was also subject to detailed investigation in Australia during the mid-nineties.

This paper is written to evaluate the recommendations of the Taylor Committee of Inquiry into a Comprehensive Social Security System for South Africa: means tests should be abolished and the taxation of retirees and retirement funds increased in order to compensate. It attempts to focus on these two interrelated issues.

The conclusion is that in South Africa, Australia and the UK means tests cannot be justified in their current form. The standard justification for means tests is that they make state pensions more affordable by targeting them towards those in greatest need. Means tests can however be seen as a tax on other income (and assets) in which case they are unrelated to questions of expenditure and affordability. A more careful evaluation of means tests against the different criteria of social justice suggests that the major problems are those of an unwarranted interference in the lives of pensioners and the efficiency of administration and incentives. It is not so much about the money but the mechanisms of the means test.

*Keywords: State pension; Superannuation tax, equity; incentives; saving; retirement*

## 1 Introduction

### 1.1 Structure

Part 2 is the main part of the paper. In it, the policy issues governing means tests and the taxation of pension systems are systematically evaluated against a range of criteria required by justice. The criteria used are need, equality, efficiency (covering administration and incentive impacts), liberty (including freedom from unnecessary administrative interventions) and just deserts. As is appropriate when considering political questions, the third part considers the institutional environment and the interests of the most important participants in the institutional structure – private and public. The paper then goes on to suggest possible reasons for the absence of debate and the perpetuation of means tests, and makes recommendations as to how the policy issues can be more systematically addressed.

### 1.2 Scope

The first-pillar pension under consideration is that paid from general revenue to those over some relatively arbitrary retirement age. The needs of those below this age are not considered. I am concerned here with arrangements in South Africa, Australia and the United Kingdom (UK), being most familiar with their systems. The arrangements of interest are the state pension and means tests, how they are determined and administered, and to a lesser extent the tax treatment of contributions, investment income and benefits paid by pension or superannuation arrangements.

The paper includes no detailed analysis of the variety of different allowances and variations, although there is some discussion of the principles of grandfathering arrangements. There is also no specific costing of any proposals, as such specifics relate only to a particular year's government budget, and irrelevant to the debate about general principles.

Means tests and pension and superannuation fund taxation are not always considered together. From a policy perspective, however, it is difficult to consider one without the other. The question is discussed from different perspectives at other points in this paper. At this point it is suggested that there must be a *prima facie* case that the fungibility of money applies to taxation and the clawback of social security benefits required by tests of income.

## 2 Justice

This section first looks at the relevance of justice to this topic, and then applies the five criteria mentioned above to the question of means testing and taxation. The criteria used find common justification in our recognition of the dignity of every person, which has a symmetry with our own self-respect. While they are debated, the criteria are not novel and would have to be mentioned in any serious application of moral philosophy to financial or social questions, as they are in chapters 7, 9, 10 and 11 of Hausman and McPherson (1996) for instance. Their application to the question at hand, however, does not appear to have been done systematically.

Similar analyses of the related subject of social security and the taxation of investment income have been performed. Diamond (1977) evaluates the US social security system explicitly in terms of redistribution, market failure, paternalism and efficiency. McNulty (2000) examines taxation issues using the criteria of fairness, economic allocative efficiency, welfare, and simplicity, with fairness incorporating notions of equality, reward and retribution. Fairness is also used in this paper to describe this particular subset of the justice criteria.

Discussions on the relevance of justice frequently bring forward the arguments that the concept is personal and that it is irrelevant to the way people behave. Neither is entirely true.

### Personal

People certainly place a different personal value on the different elements of justice. Europeans appear to place a much greater value on equality and a lower value on liberty than North Americans (Alesina *et al*, 2004). Union members usually place more emphasis on equality than managers - and less on desert. MacIntyre's (1988) different intellectual traditions of rationality and justice provide different rationalizations for this variety, but it would be a mistake to see the variety as proving that our views of justice are entirely personal with no wider application. Without the idea of justice, government could be based only on the whims of the powerful. There is widespread agreement on the procedures required to attain it, and much on its constitution. There is near universal agreement of what constitutes gross injustices: exploitation, corruption, etc.

Tyler and Smith (1995), in a review of the social science literature on justice, show that people are often more concerned with just procedures than just outcomes. The argument being made here is that each of the criteria has an absolute value in the process: *ceteris paribus* it is never wrong to value people's needs, create greater equality, efficiency and liberty or give people their just deserts. The subjective personal differences arise from the compromises that practicalities force on us. In another paradigm, justice gives to each person a set of minimum human rights. Our indignation is justified if the criteria or the rights are not considered in the process. To think otherwise is confused, deviant or malicious. The critical issue is the process rather than result: one might justifiably consider a criterion or right and decide to override it in particular circumstances.

## Relevance

The view that justice is irrelevant to people's behaviour can only be sustained by a cynicism that not only holds that people exclusively pursue their own self-interest but that they are not prepared to compromise for the common good.

While this view may have some traction in the economics literature as justified for instance in Stigler (1982), it finds minimal acceptance in any other discipline. In politics and philosophy justice provides the rules that allow for the production of the common goods of security and the other benefits of good government. As Lucas (1980) puts it: "Justice is the bond of society ... the condition under which I and every man can identify with society, feel at one with it, and accept its rulings as my own." Even the most self-interested must take note of it if they are not to be excluded from society.

From the other social sciences, Tyler and Smith (1995) confirm that:

"People's actual behavior is also strongly linked to views about justice and injustice. A wide variety of studies link justice judgments to positive behaviors such as willingness to accept third-party decisions; willingness to help the group; and willingness to empower group authorities. Conversely, other studies link the lack of justice to sabotage, theft, and on a collective level, to the willingness to rebel or protest. In other words, how people feel and behave in social settings is strongly shaped by judgments about justice and injustice."<sup>2</sup>

### 2.1 Liberty

This is perhaps the easiest criterion to deal with. In general, people do not like to be told what to do. Intervention of government in the lives of people is undesirable *per se*. Where it is necessary, it should be minimized by number, extent and impact:

- One intervention is better than two.
- Intervention in one life is better than intervention in two.
- An intervention that takes one hour or costs one dollar is better than one that takes or costs two.

The implications in this context follow:

- A single system to allocate money to individuals and to recoup from others is preferable.
- It should have as few rules as possible.
- It should require the least possible effort from those involved.

With means tests, the work of the tax authorities in making income assessments is duplicated by the welfare authorities. The tests are applied at much lower levels of income than those considered for tax purposes and also apply to assets ignored for tax purposes.

It can be noted that apparently respectable discussions of social security issues, such as Feldstein (1985), assume that a large proportion of the population are myopic and can be justifiably compelled to act in a particular way. In the case of pensions, they can be forced to contribute, or be subject to the indignity of detailed investigation of their means. This line of thinking appears to fall short of justice in that it would require a careful analysis before deciding people were myopic. Even if they were found to be so, procedural justice would

require there to be a careful balancing of the advantages of intervention against the loss of liberty.

Hancock *et al* (2005) suggest that the British pension-credit may provide a test of extent of the indignities created by an intrusive evaluation of means. The UK pension credit is a means-tested top-up of the non-means-tested basic state pension. The take up rates are relatively low: the explanation appears to be that the costs of claiming – in terms of effort or social stigma – outweigh the benefits. A means-tested pension is devalued by the cost of obtaining it.

## 2.2 Needs

Meant by needs is the wherewithal for a minimum acceptable standard of living. If the retirement age is set so high that those above the age are not readily able to work for a living, need provides a ready justification for the payment of a pension to those without another source of support. It does not however provide a justification for means tests.

### 2.2.1 The minimum standard

Open to debate is what constitutes a minimum acceptable standard of living. It must clearly include a place to stay, enough for basic water, food and clothing and basic health care. This paper is not intended to debate what constitutes an adequate level as it is clearly highly context specific. Minimum pensions, in the countries discussed here, also appear to be somewhat higher - for most recipients - than that required for bare necessity. This is contentious, but the evidence is that even the relatively small South African pension raises whole families out of poverty - as, for instance, suggested by Case (2001).

Contention about this issue arises from a common argument that state pensions are required to deliver pensioners from poverty. A recent UK government publication<sup>3</sup>, for instance, boasts that millions of pensioners have been lifted out of “absolute poverty” which is defined in a footnote as 60% of the national median disposable income. This is however a measure of relative not absolute poverty: it relates to equality rather than need. The argument from need suggests necessity and urgency. A view that the large proportion of the population of Australia or the UK living on their respective state pensions are in real economic need does not seem tenable.

In South Africa, 40% of children are reported as being clinically malnourished. Justice would apply the same standard of need to all members of society – not just pensioners. In the face of the needs of the families that do not include a pensioner, the argument from need - to increase the minimum income of pensioners – appears impossible to sustain.

### 2.2.2 Perceived needs

To check this conclusion, one can ask whether poorer people actually consider their retirement income to be sufficient. In an international survey<sup>4</sup>, AXA finds that significant numbers of retirees do regard their income as insufficient. This varies from 30% in Canada to 60% in Japan, with Australia at 36% and the UK at 40%. The US percentage is 31%, which varies from 15% for individuals with incomes in the top third of their survey to 64% for the low income third. This latter breakdown is unfortunately not available for other countries. One conclusion that may be drawn is that the absolute level of income is not the only issue that leads to dissatisfaction. This again suggests that equality and not need is more likely to be important when setting the level of a state pension.

In their evaluation of public attitudes to pension policy in Australia, Evans and Kelley (2005) report weak evidence that older people believe that pensions should be lower than younger people think the level should be. This again suggests that need is perhaps not an issue.

### 2.2.3 Targeting

There are grounds for believing that there is no practical way of targeting benefits precisely at those that need them. The nature of the needs is complex and fluctuating; the measurement is inevitably somewhat simplistic, limited to a particular time and prone to error. Where attempts have been made at triangulation (measuring needs using different methods including surveys of the views of the poor and their neighbours), significantly different answers are obtained<sup>5</sup>. If it is true that pensions are invariably large enough to meet all essentials, there is then a strong argument for a pragmatic approach to measuring income and needs. Getting into too much detail represents a spurious level of care, and is an unwarranted interference in the lives of the poor. Income – as defined by the tax collecting agencies - is probably an adequate measure of lifestyle for most purposes.

### 2.2.4 Allowances

Cases of exceptional needs can be addressed by specifically targeted social security allowances: housing and care particularly. In South Africa, the departments of health, housing and education all provide means-tested benefits. Local governments and state owned enterprises provide other allowances or price reductions to those with special needs, of whom pensioners figure prominently. Their design and implementation however requires considerably more effort than has been allocated.

These allowances appear to offer little in the way of a systematic approach to the provision of needs, but are often a further offence against liberty with their intrusive questions and their artificial incentives to distort spending patterns. Cheaper prices for some items in a consumption basket often come with a higher cost in others. Rural areas are a case in point with cheaper housing and perhaps food but much higher costs of transport and health care<sup>6</sup>. How can a local government tell that subsidies for urban housing are targeted at the neediest? There is a vast array of different needs and expenses, and the enormous difficulty in calibrating benefits to meet them undermines the rationale for having specific allowances.

Social security departments do not normally appear to make any systematic evaluation of the standards of living of different groups of recipients. Travers (1995) makes this point in the Australian context. Perhaps as a result of a recommendation in the Taylor Committee report, the South African Department of Social Development has recently commissioned a Human Science Research Council's survey of social grant beneficiaries: two waves of a panel survey were performed in 2005. This is to be welcomed and perhaps imitated. If the welfare departments cannot measure needs, however, it would not seem that other arms of government are likely to be able to do so.

These other means tests are not the particular concern of this paper as they impinge on the needy other than the aged. To the extent that they are important to pensioners, two points can be made. The first is that any analysis of needs should be holistic and take all means and expenditure into account. This may be appropriate in managing long term care for the aged and possibly in offering subsidized housing.

The other point, deriving as much from the principle of efficiency as from need, is that some of the basic needs or rights can profitably be offered in kind. This is normally the case for medical care, which is effectively free in all three countries for those prepared to queue at public hospitals. Many South African municipalities have introduced a "life-line" tariff for

utilities that provide a minimum supply of water and electricity free to every household. These are to be preferred to means-tested subsidies.

There are other types of self-targeting benefits that may not be appropriate. Hancock *et al* (2005) were quoted earlier in suggesting that means tests introduce various costs and create a social stigma that helps target pensions at those that need it most. There is some attraction in this type of self-targeting, but it should be noted that the neediest people may be excluded from benefits. It is far from clear that social stigma will select the neediest; it will certainly select the shameless, but the impoverished *prim* may prefer to starve.

## 2.3 Equality

If pensions are greater than the amounts required by urgent need, equality provides justification for their current size. It is however difficult to find a justification for means tests arising from this criterion. One possible exception is raised in subsection 2.3.7.

### 2.3.1 The principle

Equality refers in this case to equality of welfare, interpreted broadly, of income and of status. For Christian, socialist and economist RH Tawney: “What is repulsive...is that some classes should be excluded from the heritage of civilization which others enjoy, and that the fact of human fellowship, which is ultimate and profound, should be obscured by economic contrasts, which are trivial and superficial.”<sup>7</sup>

Equality can be variously justified as desirable for its own sake, as maximizing society’s total utility from the widely observed fact that marginal utility tends to decline with income, for its impact on improved health (Wilkinson, 2005), for its contribution to the development of mutual trust and social capital so discouraging crime (Uslaner, 2002), or because it leads to greater happiness (Layard, 2005), although Alesina *et al* (2004) suggest that this does not apply universally. Tyler and Smith (1995) refer to extensive documentation of how feelings of relative rather than absolute deprivation underlie much social unrest: it is the inequality that seems to provide the spark.

In order to clarify a point for the intended audience of this paper, it should be emphasized that the argument here is that – if there were no other considerations – everyone should, morally, have an identical amount of money to spend. This is clearly a fundamental assumption of those who would incline to the political left. It is also, just as clearly, not recognized by some on the political right. The consequence of the model of justice used here is that failing to recognize equality as a principle is wrong. (Having considered the desirability of equality, one might however make a just decision that does not promote equality.)

As this may appear a rather bold claim, some further discussion may be warranted. The argument for equality of spending power is analogous to that of equal votes. They both depend on the essential equality of persons (of adult age and perhaps excluding a limited number of others for reasons of their personal competence or as punishment.) As an example of its application which may be easier to accept, one might consider the shares given to each adult in the privatization of some state-owned firms in Eastern Europe. The principle may be more acceptable if it is couched in such terms: if there is largesse to distribute, it can be fair to distribute it equally.

Equality should incorporate both horizontal equity, which means like people are treated in the same way, and vertical equity, which means that differences in treatment are proportional to the differences between the people concerned. In terms of taxation, horizontal equity requires those of equal income to pay equal amounts of tax. Vertical equity requires that the rate of tax

applied to people of different income increases smoothly with their income and requires increasing marginal rates of tax.

### 2.3.2 The measures

A case can be made for a system of benefits and taxation that is more cognizant of purchasing power, but for the sake of practicality, this section only considers net income available for spending. Equality would be fully served if income tax and social security benefits left everyone with the same spending power.

Mehran (1976) considers some of the single measures of equality that provide some measure of the dispersion from complete equality, the best known being the Gini co-efficient. Single figure indices however often hide as much as they reveal, and there are considerations not captured by any one of them.

Rawls (1971) suggests that – rather than equality – people would choose a maximin principle – that maximized the income of the poorest - if they did not know where they would fit in the income distribution. While this may be extreme, the income of the poorest people may be considered of special importance. This is related to the object of equality of status to the extent that it is related to income inequality. If this is so, significant gaps between the incomes of neighbouring classes might also be considered as undesirable.

Another question is the period over which to measure equality. In practice, this reduces to whether people should be permitted to defer their income when they are being taxed at higher marginal rates to years when the marginal rates are lower. As the tax year is essentially arbitrary, it seems acceptable for people to be able to make such a deferral so long as the income deferred is eventually taxed (even if the person has died). Emerson (2005;4) says it has been argued that tax deferral is unfair, presumably because it largely benefits the wealthy. In fact, it identifies and benefits wealthy people who will have a lower marginal tax rate in retirement, and so can be seen to discriminate more accurately between degrees of wealth.

### 2.3.3 The taxation of income

Perhaps the most hotly contested of taxation debates is whether tax should be imposed on income or consumption, or more particularly whether it is fair and efficient to tax investment income. McNulty (2000) provides a detailed evaluation of the debate, finding no obvious grounds to prefer one over the other. Changing from one to the other does however create significant transitional issues and is clearly not desirable. The current system in most countries of a balance between income and consumption taxes seems worth retaining.

In this context, it seems clear that the taxation of investment income contributes to equality. Positive real investment income (after adjusting for inflation) undoubtedly gives the beneficiary greater spending power. It is therefore reasonable that it should be taxed. There is a view that this represents double taxation, but this – as McNulty (2000) and others have shown - is nonsense. If I earn 100 and pay tax of 20 I have been taxed. If I earn 100 the next year and pay tax of 20 again, I have been taxed twice but this is not double taxation in the sense of being unfair – it is new income. If I invest 80 of my earnings and earn a real return of 5, taxing the 5 is not double tax, but a tax of new income. (Taxing income annually does mean that the rate of tax that applies to the investment income earned over a number of years is higher than that earned over one year.<sup>8</sup> This is another consequence of the arbitrary annual taxation of income, and is not necessarily unfair, although might be characterised as double taxation.)

This misunderstanding takes a different form in the context of pension taxation, in that it is argued that double taxation occurs when both investment income and benefits are taxed. There is, in this case, double taxation, but it is not unfair as the taxation of benefits is matched by the exemption of contributions as shown by Brown (1993).

Those with investment income are, by virtue of their assets, wealthier than those with similar earned incomes. Both vertical and horizontal equality would thus allow for a higher rate of marginal tax on investment income. The argument is sometimes made that taxing the investment income of retirement funds is unfair to the poor. This is straining at a gnat and swallowing a camel. The two important points not made are that the poor face higher rates of clawback from means tests, and that most of the investment income of retirement funds is being earned on behalf of the wealthy. The poor with retirement savings are, probably, better off than those without, so using a higher rate of tax than their direct marginal rate is not an offence against horizontal equality.

### 2.3.4 The implications

From the perspective of equality of spending power, it is clear that tax and state pensions (and thus the means tests that determine them) should be considered together. They are the two complementary parts of any system of creating equality: amounts taken from the wealthy and given to the poor.

It also becomes clear that means tests that apply a clawback of benefits at a higher rate at lower incomes than rates of tax at higher incomes are an offence against vertical equity. In South Africa, the means test on private income reduces the pension by 50% against marginal rates that currently vary from 17% to 40%. In Australia, the rate of clawback is 40% against tax rates that vary from 16% to 48.5%, but the taxation of superannuation contributions can increase the loss to as much as 49% of the proceeds. The UK basic rate of clawback is 40%, which is the same as the highest marginal rate of tax.<sup>9</sup>

### 2.3.5 Redistribution

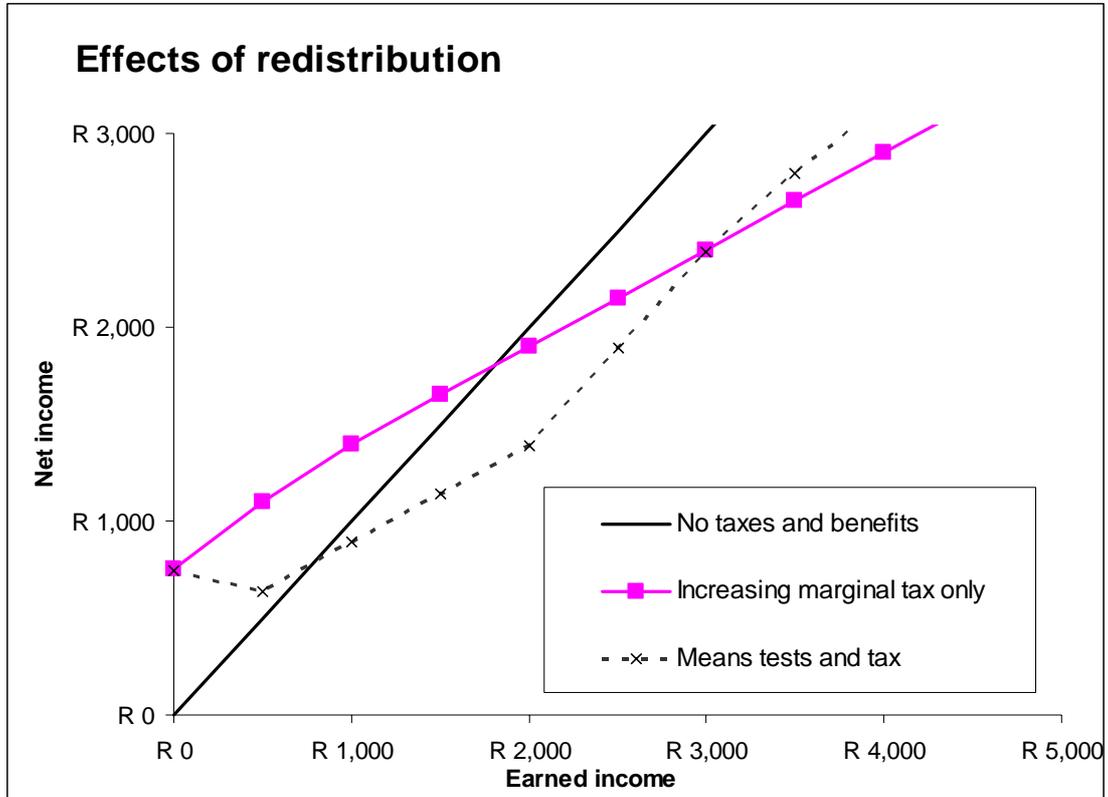
Arguments for means tests refer invariably to the affordability of the state pension. This is however a limited perspective, seeing the issue as that of allocating the government's welfare budget and failing to see means tests as revenue raising items. The welfare budget should also be seen as part of government's role in the redistribution of income. To characterize this as a question of how much the rich can afford to give to the poor is a caricature. Questions of redistribution involve the division of a common pie; some of the slices may appear too big or too small but talk of affordability is meaningless.

The major issues are illustrated by figure 1. The straight unmarked line shows net income equal to earned income – if there were no taxes and benefits. The dashed line shows – more or less - the effects of the South African means tests on net income after adding in the state pension and deducting the clawback and tax. The other marked line shows the impact of abolishing the means tests and only applying higher tax rates. What is made clear is that means tests would target the poorest if it were possible to identify them accurately, but that there are significant penalties applying to those just above the lowest income band.

The graph shows the reality in South Africa that, at some income levels, the marginal rate of clawback exceeds 100%. The higher marginal rates arise from the use of means tests to clawback some of the allowances mentioned in subsection 2.2.4. These include allowances for housing, rates and taxes, school fees (which are relevant in multi-generational homes where pensioners support grandchildren) and health care. In Australia, higher marginal rates apply at the point where the pensioner loses rights to a pension, which also mean loss of

access to the Pharmaceutical Benefit Scheme and various subsidies on transport, rates and most importantly, residential aged care. At some incomes, the marginal rate therefore also exceeds 100%. Hancock *et al* (2005) report that it only reaches 91% in the UK.

**Figure 1**



Before moving on to the other criteria, it is useful to consider the balance of high and low incomes in the countries being considered. The UK and South African budgets<sup>10</sup> show social security payments at some two thirds of personal tax (including social security contributions in the UK). In Australia, official figures<sup>11</sup> show personal tax is more or less balanced by social security spending. Abolishing the means tests would represent additional expenditure of some 5% of the respective national budgets. Some half would be recouped from simplifying the tax system by removing tax concessions to the elderly. The rest would have to be funded by an increase in tax or a reduction in the level of benefit. How taxation expenditures on retirement provision can be reduced for this purpose is discussed in section 3.1.3.

The arguments from equality therefore seem clear. The state pensions do contribute to equality, but greater equality would arise if the combined rates of clawback and tax increased with income. In terms of figure 1, this paper is intended to address only the kink (or dip) in the line created by the means test, and to suggest that it is unnecessary and unfair. The degree of redistribution between pensioners changes the slope of the line, the degree of redistribution between generations its intercept. A range of different lines would be compatible with justice, but only a smooth curve, with a declining slope, satisfies the requirements of equality.

### 2.3.6 Lifetime considerations

Spread over a lifetime and looked at from the impact on average rates of tax, the means tests on pensions are not particularly significant. Given that contributions to retirement funding represent a relatively small part of any individual's wages, the effects of inequalities in the

clawback and taxation of retirement benefits is considerably diluted. A 50% clawback of retirement benefits that have a present value of 10% of salary over the lifetime increases the marginal – and average – rate of tax on income by 5%. As a large proportion of the benefits can be taken as tax-favoured lump sums, the actual impact is reduced to perhaps half in current South African circumstances<sup>12</sup>. This means that it is probably less than 20% of the income and expenditure tax paid by South Africans earning an average income. While significant at any one time, this is less than some of the changes that can be observed in average tax rates in the past.<sup>13</sup>

### **2.3.7 Comparison with unemployment and disability benefits**

There is another argument from equality that needs consideration.

Pensions could conceivably be seen as unemployment or disability benefits based on a presumption that people over the retirement age are unable to work. Certainly, state pensions, unemployment and disability benefits are often set at more or less the same level. If one were just to consider the recipients' material needs, it would be fair to treat the beneficiaries equally and apply similar means tests.

There are however wider economic and social reasons to encourage people of working age to return to the workforce, as well as considerations related to their own welfare. Disabled people need rehabilitation for their own sake. Some return to the workforce is almost always a possibility, and is generally recognised as a cure in its own right. Unemployment is similar: both from their own perspective and that of the national economy, people are better off if some way can be found for them to return to work. The tests that apply to unemployment and disability might better be called capacity tests rather than means tests. They should also include additional requirements to seek the necessary medical attention, or to be actively searching for a job.

These considerations barely apply to the retired. In many cases, they might well prefer to continue to work, but the personal, social, economic and budget imperatives are not as pressing. Even if the costs of re-entering the workforce do not rise with age, there is a shorter period over which to recover the human capital invested and it becomes increasingly uneconomic to attempt to do so. If the retirement age is set high enough, it is a reasonable presumption that the pensioners cannot economically return to the workforce.

This suggests that abolishing the means test has an increasingly strong case for those at more advanced ages. It is interesting that Travers (1995) reports that, for a period during the seventies, the means test was abolished in Australia for those over 70.

For younger retirement ages, it becomes likely that retirement, unemployment and disability benefits are confounded. Means tests on their own will discourage people from returning to the workforce, but this brings us to the incentives discussed in the next section.

## **2.4 Efficiency**

Efficiency is taken to include lower costs of administration and the provision of productive incentives. Efficiency is not normally explicitly considered as an issue of justice, but it must often be considered in order to make a balanced evaluation of policy options. It is argued here that it should function as a criterion of justice. The question to ask is whether it would be unjust to fail to meet one of the other criteria because of cost considerations? If not, then efficiency would appear to act as one of the components of justice.

In some of the social security literature<sup>14</sup>, efficiency refers to the proportion of social security payments that are paid to those under some poverty level of income. As concluded in section 2.3.5, this artificially characterizes the question as a budgeting one or as an artificial caricature: how the state (on behalf of wealthy taxpayers) can best afford to target a needy group?

This section considers deadweight losses that arise from means tests. It concludes that the criterion of efficiency produces strong arguments against means tests. The next sub-section discusses administrative difficulties and costs; the next four discuss incentives to save.

### 2.4.1 Administration

Means tests in the three countries being discussed are controlled by government departments responsible for social security and not those responsible for finance, which control the collection of taxes.

The challenges of auditing assets and income for means tests are difficult to overstate. Apart from catching those that cheat, one should review records of income from casual jobs and the renting of rooms, interest on formal and informal loans, pensions and transfer payments, and – particularly in South Africa - estimate income in kind from subsistence farming. This is impossible given the budgets of these agencies. The UK website mentioned in footnote 9 has a calculator that asks 48 questions in order to provide a first estimate of the means-tested benefits available. Centrelink is the agency responsible for implementing the tests in Australia. Its website lists seven different kinds of income and six different types of assets that have to be considered twice a year. In many instances, there is no way in which the answers can be independently confirmed, while the level of complexity makes the assessment difficult even for diligent applicants and competent administrators with goodwill and plenty of time.

The difficulties are illustrated by a recent audit of Centrelink – reported in Pender (2004). The audit found the agency made some 250,000 errors a month, with an “actionable” error in 52% of the cases investigated, and that almost all folders contained administrative errors. Another audit of Centrelink by the Australian National Audit Office<sup>15</sup> reviewed the files for proof of identity and found only 24% completely correct, although most of the errors were of a minor administrative nature. This is not to suggest that Centrelink is any worse than other agencies. It is to suggest that the proper administration of means tests is not possible. There is far too much to do.

Any attempt to quantify the additional costs of means tests is necessarily suspect given that they are almost certainly not performed properly. The National Association of Pension Funds (2005; 35) however quotes costs reported to the Parliamentary Select Committee of £54 annually for the UK means-tested pensions credit against £5.40 for the non-means-tested basic pension. The Select Committee found that the Pensions Service (the UK social security agency) was to be commended for its accessibility, but expressed concerns with accuracy rates purported to be at 90%.

Abolishing means tests would make administration possible. Three quarters of the questions in the UK calculator would be irrelevant (assuming that many of the social security allowances would be reduced to take the universality of the pension into account) and much the same would apply in other countries. All the difficult questions relating to assets and private income would be abolished. Pensioners could then be subject to the same tax rules as other people.

There would – of course - be the additional administrative work of paying pension benefits to more people. This would however not appear to be a major burden as almost all the wealthier people concerned would have bank accounts and the exercise would be largely automated. For those paying more tax than the pension, it could be avoided altogether if there were the necessary electronic linkages.

#### **2.4.2 Unenforceable law is unjust**

Laws that cannot be enforced are unjust laws as they are likely to fail each of the criteria at some point. The administrative difficulties referred to in the previous paragraphs indicate that means tests cannot be enforced uniformly. Anecdotes from South Africa and Australia suggest that cheating is widespread. This would be reason alone to attempt to find an alternative to means tests.

#### **2.4.3 Work incentives and redistribution**

Redistribution of income requires higher tax rates on higher incomes, and creates a risk that this will act as a disincentive for higher earners. It does however reduce taxes on lower income earners which is likely to have compensating effects. We are here concerned with changing the incidence of tax and clawbacks on retirement income, which is likely to have an attenuated impact on motivation during the working years.

The studies reported by Tuomala (1990) suggest that "most labour supply studies of men seem to indicate backward-sloping supply curves." Higher income taxes can lead to men taking less leisure because they need to work harder for the same standard of living (described as an income effect), but leisure is relatively cheaper because of the loss of the lower net wage, which may mean that more leisure is taken (described as a substitution effect). It appears that the income effect is often more powerful for men. Studies of women on the other hand suggest normal supply curves: lower tax rates increase work effort.

This suggests that it would be very difficult to make the case that small increases in the marginal tax rate of the wealthiest are likely to have a significant impact on their incentive to work hard. The other suggestion relevant to South Africa is whether higher tax rates would create an incentive for the wealthy to emigrate. There appears to have been no local research into either of these incentive questions, and the ambivalence of other research suggests that they are unlikely to be of great importance. They are therefore not considered further.

There is the additional question of whether people understand the size of the incentives anyway. Hills<sup>16</sup> reports that in the UK "only 17% of basic rate taxpayers and only 28% of higher rate taxpayers can identify their own rate of tax relief."

#### **2.4.4 Deferral incentives and life time smoothing**

It is frequently argued that tax incentives are required to get people to save enough for their retirement through private retirement funds. This again assumes a level of myopia that is difficult to test because almost all countries offer some level of incentive, compulsion or minimal provision. The AXA survey<sup>4</sup> suggests that pensioners are, as a whole, happier with their income than those still working, which may mean that the balance is about right.

While the case for myopia may be overstated, there is the alternative argument, mentioned in 2.3.2 above, that people whose income is "bunched" ought to be given an opportunity to lower their average rates of tax by deferring income.

Whether seen as incentives or opportunities for tax rate smoothing, it would seem that the rewards for deferral should be applied more or less equally to different earning patterns. The current system however creates significant disparities for three different earning patterns:

- In some cases the marginal rate of deduction on contributions will be the same as the marginal rate on pensions. This is likely to apply to those at the extremes of the income distribution. They see no gain from deferment.
- Those in the middle of the income distribution will be able to claim tax deductions on contributions (technically described as employer contributions in Australia) at a higher rate than the rate of tax that they pay on pensions. As people may be in the position of paying no tax on their pensions, this difference can be as high as 40% in South Africa and the UK and 33.5% in Australia (where the contribution tax is not refundable).
- In many cases however, the rate of tax saved on contributions is lower than the rate of clawback imposed on the pension. For those on low wages, they might obtain no deduction for contributions and yet suffer loss through the means test at 50% in South Africa, 40% in the UK and 49% in Australia (where the 40% rate of clawback has to be increased to allow for the 15% tax on superannuation contributions, which is not refunded).

Concessions on investment income change this ratio. The longer the concessions are in force, the greater the benefit of contributing. The combined effect is shown in table 1 for a variety of South Africa rates. An Australian table would follow the same pattern. Hills produces a range of between 80% and 255% for the UK equivalent of the last column.<sup>17</sup>

There are indeed significant rewards for upper-middle-income people, but for the quarter of the population (in all three countries) that is likely to be drawing a reduced state pension as a result of means tests, there are significant disincentives to deferring income. People in this category will be misled by generic financial advice that retirement savings are tax advantaged.

As already noted, lump sums enjoy significant tax concessions in every country. In South Africa, members of provident funds can take their entire benefit as a lump sum, which may often be too small to be taxed so the members face a marginal rate of zero. All superannuation benefits in Australia can be taken as lump sums with a significant tax free allowance, but the un-refunded 15% tax on contributions means that the effective rate is at least 15%. In both countries higher marginal rates apply to larger payouts. In the new UK system introduced in April 2006, 25% of the value of the pension at retirement will be tax free.

The need for an incentive is reduced in Australia where contributions are compulsory. Additional voluntary contributions (whether they are made in or out of the superannuation system) are however also subject to means tests.

### **2.4.5 Work incentives after retirement age**

As discussed in 2.3.7, retirement, disability and unemployment benefit issues are difficult to distinguish if entitlement to pension is set at a fairly young age. Remaining employed becomes less economical in any event, and high rates of clawback create significant disincentives to work. With South Africa's high levels of unemployment, encouraging early retirement can be seen as opening up jobs for younger people. The flat population pyramid makes it a relatively inexpensive way of providing unemployment benefits. For countries facing population aging that have labour shortages, higher retirement ages appear to be a necessity, and people ought to be encouraged to remain in the workplace as long as possible. Means tests ought then to be supplemented by other measures to encourage people to return to work.

**Table 1: Incentives to defer income - South Africa**

Assuming 10% nominal investment return, 9% tax on investments

	Marginal rate of deduction for contributions	Years of investment income tax concessions	Marginal tax or clawback rate on benefits	Benefit: contribution ratio
Same tax rates	18.0%	10	18.0%	104%
	18.0%	40	18.0%	128%
	40.0%	10	40.0%	116%
	40.0%	40	40.0%	227%
Reducing tax rates	18.0%	10	0.0%	127%
	18.0%	40	0.0%	156%
	25.0%	10	0.0%	144%
	25.0%	40	0.0%	205%
	30.0%	10	0.0%	158%
	30.0%	40	0.0%	251%
	30.0%	10	25.0%	118%
	30.0%	40	25.0%	188%
	35.0%	10	18.0%	143%
	35.0%	40	18.0%	252%
	35.0%	10	25.0%	131%
	35.0%	40	25.0%	231%
	40.0%	10	0.0%	193%
	40.0%	40	0.0%	379%
	40.0%	10	30.0%	135%
	40.0%	40	30.0%	265%
Increasing rates	0.0%	10	50.0%	48%
	0.0%	40	50.0%	39%
	18.0%	10	50.0%	64%
	18.0%	40	50.0%	78%
	30.0%	10	50.0%	79%
	30.0%	40	50.0%	125%
Ratio of greatest to least				9.70

The table compares the after tax and clawback value of benefits against the accumulated value of contributions with normal tax (outside the retirement fund tax regime) and no means test.

#### 2.4.6 Tax on investment income

It can be seen from table 1 that the effect of the tax concessions on investment income (which can be seen by comparing the effects of 40 years vs. 10 years of contributions) is small relative to the differences between the rate at which contributions are deducted and the rate at which they are taxed. The concessions do however have a deadweight loss as they provide a distorting effect on investment decisions, allowing for a variety of tax-planning strategies.

It is however frequently argued that tax concessions for savings have positive externalities in that they promote investment and increase economic growth. It is perhaps necessary to rehearse, briefly, the refutations of each of the three mistakes in this argument.

Saving in tax-favoured superannuation barely increases savings. In a review of the literature on factors affecting saving, Smith (1990) finds that savings through private-sector pension funds are likely to reduce other types of savings, although they do contribute to an increase in

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overall savings. Knox (1992), in a typical study, has found that the reduction in other forms of savings means that total personal saving appears to be increased by only 30% to 40% of contributions to pension funds. Half, or more, of this increase is contributed by government in the form of tax concessions. Thus pension and superannuation funds make a much smaller contribution to increasing national savings than is sometimes assumed - probably less than 20% of the amounts saved.

Saving does not necessarily increase investment. The classical view is that an increase in savings will reduce the cost of investible funds, and so encourage investment. The Keynesian view is that increased savings represents a postponement of consumption, and that this will discourage investment in plant that would otherwise have provided for this consumption. While there is a positive relationship between savings and investment, it is not at all clear which comes first.

Investment does not necessarily increase economic growth. The debate about the relationship between investment and growth is unresolved. Aghevli *et al* (1990) point out that the positive correlation that clearly exists between savings, investment and growth is consistent with several different hypotheses about causes. It is just as likely that growth causes savings and investment as for savings and investment to cause growth.

If private capital accumulation through retirement savings made a difference to prosperity, one would expect a significant difference between otherwise similar economies such as those of the UK and France, and the Netherlands and Belgium, as they have taken very different paths in this respect. In fact, the differences are barely evident. It is, therefore, not true that there are proven macro-economic benefits for giving special tax consideration to retirement funds.

Even if it were demonstrated that there were significant advantages in encouraging superannuation savings, that would not by itself justify tax concessions. There are few economic activities that do not have similar advantages; as has been one of the major concerns of economists since Adam Smith, and which Olson (1965) particularly shows, the better policy is to avoid all concessions to special interests.

Table 2 provides an indication of what the incentives to defer income were to become if investment income was taxed at 30% and means tests abolished. It is assumed that no-one would save for a higher income in retirement than while they were working, and so would never be faced by a higher marginal tax rate. The range of the ratio of benefits to contributions is halved, but it remains less than 1 for those with a marginal rate of less than 30%, which may be seen as unfair. Apart from the arguments made in the fourth paragraph of 2.3.3 above that this can be reconciled with both horizontal and vertical equity, the after tax return on retirement fund investments is likely to be higher than the alternative instruments used by the poor<sup>18</sup>, or they can negotiate membership of alternative savings mechanisms that better suit their circumstances. Mandatory superannuation makes the latter impossible in Australia unless people were given the option of joining non-complying unit trusts where they paid their own tax on the investment income.

**Table 2: Incentives to defer income - South Africa**

Assuming 10% nominal investment return, 30% tax on investment; no means tests

	Marginal rate of deduction for contributions	Years of investment income tax concessions	Marginal tax or clawback rate on benefits	Benefit: contribution ratio
Same tax rates	18.0%	10	18.0%	94%
	18.0%	40	18.0%	72%
	40.0%	10	40.0%	105%
	40.0%	40	40.0%	131%
Reducing tax rates	18.0%	10	0.0%	115%
	18.0%	40	0.0%	88%
	25.0%	10	0.0%	130%
	25.0%	40	0.0%	116%
	30.0%	10	0.0%	143%
	30.0%	40	0.0%	143%
	30.0%	10	25.0%	107%
	30.0%	40	25.0%	107%
	35.0%	10	18.0%	129%
	35.0%	40	18.0%	144%
	35.0%	10	25.0%	118%
	35.0%	40	25.0%	132%
	40.0%	10	0.0%	175%
	40.0%	40	0.0%	218%
	40.0%	10	30.0%	122%
	40.0%	40	30.0%	153%
Increasing rates	0.0%	10	0.0%	87%
	0.0%	40	0.0%	44%
	18.0%	10	18.0%	94%
	18.0%	40	18.0%	72%

Ratio of greatest to least

5.00

#### 2.4.7 Alternative investments

Paying inflation protected state pensions to all pensioners would provide them with a useful additional investment instrument. It would also allow for retirement funds to adopt a more adventurous investment policy with their investments.

The introduction of a universal government guaranteed pension would reduce – even eliminate – calls for the state to artificially create instruments that match pension payments or otherwise subsidize pensions for the wealthy. Blake (2000) notes suggestions that the state should provide not only more long-term inflation-linked assets, but also instruments that would absorb some of the longevity risk inherent in annuities. Vitas (1998) says that Chile and other South American governments provide minimum guarantee of investment returns, which has a similar effect although with moral hazards.

#### 2.5 Just deserts

Recognizing just deserts is equivalent to saying that people's actions matter and must have their proper consequences. In the context of benefits and taxation, this suggests a correspondence between the two. It is possible to find some arguments for means tests from this perspective, but they largely vanish under closer scrutiny.

### 2.5.1 State pensions

State pensions, unlike private income, might be said to be un-deserved and thus it could be argued that they can be treated differently when it comes to clawing them back.

The amounts of clawback are determined by reference to private income and not the pension. In order to justify means tests using an argument from desert, one would have to make a far more difficult case. It would be necessary to prove that those on a partial pension (subject to the means test at 50% in South Africa) were less deserving than those with the full state pension.

It would appear to be an impossible task to justify a blanket clawback without a much more careful analysis of just deserts. Needy pensioners may have been significant contributors to the fiscus over their lifetime, and their current low income may be the result of economic bad luck, poor health, or a commendable generosity - rather than idleness or imprudence. From the perspective of desert, such distinctions would have to be made. That they have not been made, suggests that this idea of deserts is not regarded as an important justification for the high rate of clawback applied in means tests.

One could imagine practical ways of implementing such a policy: for instance, applying it to those who had not been taxpayers for 20 years or more (as is the case in some countries), and also to those who could not explain why they were no longer in possession of their lump sum retirement benefits. Alternatively, it may be regarded as just too hard to achieve, or desirable to forgive undeserving recipients for their failure to pay adequate taxes.

Another response would be to justify the payment of a universal (non-means tested) pension on the grounds of desert rather than need or equality. In the first place, most pensioners are likely to have worked since they were children, and even if they have not paid income tax or contributed greatly to indirect taxes, they are all likely to have made some contribution to the economic wealth of society. It can also be argued that some of the state's taxation income arises from economic rents (e.g. the value of land, mineral wealth and band-width) that should be given equally in some form to all residents. It appears, from research such as Evans and Kelly (2005) and St John and Willmore (2001) that there is majority public support for universal pensions in a number of countries including Australia and New Zealand, which has had one for some time. It can be argued that a universal pension would make a real contribution to social solidarity.

### 2.5.2 Grandfathering

The taxation arrangements of all three countries are greatly complicated by the protection of historic privileges, or grandfathering. This applies in some cases to allowances and income that are not means-tested, and to income and benefits that are not taxed. The resultant complexity is widely regarded as expensive and a deadweight loss on the economy.

One argument made to defend grandfathering is the rule against retrospective legislation. The rule relates to the procedural principle of certainty. It relates to desert because, in this context, it is necessary to prevent people from being unfairly penalized for making decisions that subsequently prove to be inappropriate because of changes in the law, and provides justification for transitional arrangements. It cannot however be used as a legitimate argument to protect tax privileges, to prevent government from making relatively minor changes to rates of tax, or when the individuals concerned are able to rearrange their circumstances to avoid harm that they would otherwise have suffered.

The UK is in the process of eliminating all grandfathering in its pension tax regime. South African and Australia might consider doing the same.

### **3 Reform**

#### **3.1 Bringing it together**

This part of the paper first summarizes the arguments for reform, discusses the results of the Australian debate of the nineties to understand why it failed to lead to the abolishment of the means tests, and then suggests how reform might be achieved.

##### **3.1.1 The debate**

Means tests are justified as making them more affordable by targeting the needy. It has been shown, however, that the issues are not so much about saving expenses but about distributing tax and clawback charges equitably. Means tests are a poor mechanism for this because:

- They involve a greater intrusion into the lives of most pensioners, applying an unfair social stigma.
- They are not well targeted at needs.
- They present declining levels of clawback and tax, and so are offences against the vertical equity element of equality.
- They are expensive to administer, probably impossible to do so accurately.
- If intended as incentives to save more or work in retirement, they do not fulfil this function for a large proportion of the target population.
- They might be justified in terms of just deserts, but this would require the introduction of a proportional residence requirement or a measure of how long tax was paid.
- They might be justified as treating the recipients of pensions, disability benefits and unemployment benefits equally, but differentiation can be justified in terms of the desirability (from an individual and societal perspective) to get people back into the workforce.

##### **3.1.2 The Australian debate**

The means-test debate in Australia in the mid-nineties may be instructive in understanding how other debates may proceed.

The Institute of Actuaries of Australia (1994) recommended the introduction of a universal non-means-tested state pension in a package of other superannuation suggestions. They placed a particular emphasis on the inefficiencies arising from attempts to avoid the impact of the means test – which is a real problem in Australia, but appears to be less so in South Africa. The submission emphasised that the Institute was advocating an alternative structure rather than a particular package of changes to taxation but, after some debate, modelling of the cost implications was included in this and a subsequent submission. This proved unfortunate, as Gallagher (1994) showed that the costs had been underestimated and that the proposals appeared to significantly benefit wealthier pensioners. This led Barber *et al* (1995), in their strategic review of the pensions' means tests for the Government, to reject the Institute's recommendations. The arguments that the costs were too high appear to have been accepted by subsequent papers to the Institute, such as those of Somogyi *et al* (1995) and Rice (1998).

The outcome of this debate is unfortunate. If a much better administrative arrangement happens to unfairly favour wealthier pensioners, the obvious solution is to increase the taxes that apply to this group. Such an increase would also justify the removal of the administratively cumbersome reasonable benefit limits that currently apply to the wealthiest.

### 3.1.3 Reducing tax expenditures

As discussed in section 2.4.5, abolishing means tests would mean also abolishing some tax concessions to pensioners, and some increase in other forms of taxation. Increasing the tax on the investment income of retirement funds would be an obvious source for this additional requirement. (As suggested in the previous section, another alternative would be to tax pensioners at a higher rate than other people. This would not have to be any more complicated than the current position in all three countries.)

Abolishing the means test in South Africa would cost some R10bn, which could also be recouped by taxing payments and the reduction or abolishing of tax concessions for older people. The exact amounts are not readily determinable, but it would probably not be necessary to entirely remove tax concessions on investment income (R6bn).<sup>19</sup>

Abolishing the means test in Australia would cost some \$10bn, but some 30% of this would be immediately recouped by taxing the resulting pensions, and the balance could be recouped by removing tax concessions to superannuation investment income (\$5.7bn) and removing the senior tax offset (\$1.8bn).<sup>20</sup>

The National Association of Pension Funds (2005) says the UK system has been called the “most complex in the world”. The report suggests the introduction of a citizen’s pension that would be set at a level that required no means tests. Their estimate of the net cost in 2010 is of the order of £13bn, of which £2bn would be recovered by the tax system. They suggest that the balance of the cost should be recovered from redirecting the national insurance contributions for the earnings related state scheme and raising the retirement age. UK pension funds currently pay limited tax on their investment income so there would also be scope to recover amounts from investment income.

Reducing tax expenditures on retirement funding would significantly simplify the system of retirement fund taxation, creating obvious efficiency gains to government and people who would not have to devote as much time to understanding the system (and avoiding its negative consequences):

- It abolishes means tests.
- It eliminates tax concessions currently enjoyed by the elderly.
- It allows for the elimination of the tax concessions currently enjoyed by retirement funds, which also reduces opportunities for tax arbitrage.
- It removes the need for caps on benefits for the wealthy.

Administration would also be simplified. Extrapolating UK costs of the savings credit to the other countries suggests savings in the hundreds of millions as the social welfare agencies no longer perform means tests. State pensions could be paid without deduction. Employers and financial institutions paying benefits would determine PAYG deductions on the assumption that a pension was being paid to those over the retirement age. The tax collecting agencies would be responsible for ensuring that those with multiple income sources were assessed correctly. It is not clear how much additional work this would create; for most institutions it would represent a change in the work that they do but not an increase. The Australian Tax

Office, for instance, already has data on some 50% of pensioners. The same is likely to be true in the UK and in South Africa in respect of those pensioners who have private incomes.

### **3.2 Institutional factors**

If the arguments against means tests are so strong, why do they persist? If we can find no good reasons, perhaps there are bad ones?

Lundberg (2005) discusses some of the institutional and political reasons for the structure of pensions systems in different countries. He raises the role of history, political interests and “policy entrepreneurs”. It may well be that the answer mainly lies in historical institutional accidents.

#### **3.2.1 Fault lines**

In all countries, recommendations as to the level of the state pensions and clawbacks are made by the same people who look at the levels of unemployment and disability benefits. They are given a constrained budget, and effectively prevented from considering rates of taxation.

There appears to be a wide gap between the people in the departments responsible for social security and those for taxation. The best of the former are motivated mainly by compassion, the latter by efficiency; they come from different intellectual disciplines, read different newspapers and journals, appear likely to vote for different parties and are advised internationally by different agencies. The International Labour Office (ILO) advises the former and the World Bank and International Monetary Fund (IMF) interact with the latter. Ervik (2003) and Asher (2002) comment on some of these differences.

Policy development in social security departments such as the South African Department of Social Development operates within a given budget that has to be applied to meet urgent needs and reduce inequality. The department officials are required to treat different groups of their clients fairly. There is no question of making a trade-off with the tax on investment income of retirement funds or tax concessions given to pensioners. In both cases, concessions are likely to be regarded as being favourable to pensioners in general, and thus worth supporting. Given the limited budget and the range of needs that present themselves, a steep means test meets a number of the criteria of justice listed above.

From the perspective of tax policy, social security means tests are regarded as a reduction in expenditure and not as taxation income. They do not fall within the purview of those responsible for determining marginal tax rates and the question of the taxation of retirement fund income. People developing policy face ongoing arguments that taxation should be reduced, and counting the clawback of pensions as a reduction in expenditure is consistent with doing so. Within the confines of their brief, they also meet many of the criteria of justice. The combination however does not.

#### **3.2.2 A South African Experience**

My experience in South Africa was of enormous difficulties in obtaining an interdepartmental view on the matter. I was a member of the steering committee set up to produce recommendations that arose from the National Retirement Consultative Forum in 1997. This was set up by the Department of Finance (since renamed the Treasury), as a result of the recommendations of the Smith Committee (1995), to attempt to gain a national consensus on a variety of pension issues – including all aspects of compulsory membership and taxation. The steering committee suggested to the Department, in early 1998, that the matters could not be determined independently of the Department of Welfare (since renamed

Social Development). Whether as a result, or independently, an inter-departmental task team was convened by the Department of Social Development in 1999 to review the social security system. It recommended the investigation of a comprehensive and integrated social security structure. The output of this investigation was the report of the Taylor Committee (2002) of which I was also a member. The report recommended that means tests (for pensions and other categorical grants, such as children's allowances) be abolished and the lost revenue recaptured through the taxation system. The recommendation was however overshadowed by the Committee's major recommendation (from which I dissented) of a new, non-means-tested, basic income grant payable to all residents. The controversy over the latter may well overshadow the important, unanimous, recommendation that means tests should, wherever possible, be avoided.

### **3.3 Lobby groups**

The institutional arrangements would probably not be sufficient to maintain means tests in their current form if it were not for a few powerful interests.

#### **3.3.1 Potential losers**

Potential losers may be expected to resist reform.

Major losers will be wealthier individuals who are currently benefiting from tax concessions offered to pension funds. Those currently drawing benefits will be barely affected if the majority of the additional revenue comes from tax on investment income. They could however be effected by an increase in the tax on pensions.

It may be that, in the long run, moving away from means tests would put some pressure on the level of the state pension, and so potentially also disadvantage those with the lowest income, who are currently not affected by the means test. This is to be regretted, although the argument of 2.2.2 above is that there is no way of accurately measuring who are the poorest, and that targeting is invariably spurious.

The winners are those of lower middle income who are, or would be, subject to means tests.

#### **3.3.2 The gerontocracy**

Mulligan and Sala-i-Martin (1999) describe how the old in every country, with plenty of time to lobby, extract a greater share of resources, and shape the pension system to maximise their power. Their thesis would explain tax concessions that favour the old, and how these are seldom questioned in political debates. All tax expenditure on retirement funds may fall into this category, particularly concessions such as the exemption of the investment income of pensioners within retirement funds - in South Africa and Australia.

#### **3.3.3 The industry**

The long term savings industry, which includes retirement funds, insurers, and service providers, including actuaries, has an interest in a larger, more tax-favoured, industry. In South Africa and Australia, it can be relied upon to call for the reduction of taxes on pension and superannuation fund investment income particularly.

### 3.3.4 Public interest groups

Non-government organizations can speak effectively for the rights of pensioners. They understandably interpret their role as to speak for the poorest, and so are unlikely to be immediate supporters of a change that benefits those slightly wealthier. As suggested above however, the losses to those on the lowest income will be small, and abolishing means tests is ultimately likely to benefit everyone in the lower income brackets.

In South Africa, the position is clouded by the fact that whites will benefit more proportionately from the abolition of the means test. Lost tax concessions for wealthier pensioners will however fall almost entirely on whites.

### 3.3.5 The beneficiaries

It can be noted that the beneficiaries are not likely to be represented by anyone, nor are they likely to speak up for themselves. There is evidence that they feel stigmatized.

### 3.3.6 Recommendations

If this analysis of the problem is true, the next step is to recommend that responsibility for determining means tests be transferred to the same government office as that responsible for deciding the incidence of taxation. This responsibility should extend to the evaluation of all means tests offered by central, state and local government. The clawback of means should be recorded clearly as a charge on income rather than a reduction in pensions and other allowances. If the logic of this paper is ineluctable, then one could expect such an office to recommend a move to a more just approach to means tests.

The administration of the evaluation of means should also be centralised with the administration of taxation. It should then become more efficient and lead to lower levels of intrusion in people's lives.

## 4 Conclusion

This paper has shown that there are good reasons to abolish means tests and replace them with additional taxes in South Africa, Australia and the UK. The reasons relate to money and mechanisms.

On the question of money, means tests for pensioners should not be seen as one of targeting of needs and affordability. Targeting that effects over half the pensioner population does not deserve the title; needs are invariably measured relatively and arise more from notions of equality than personal necessity; seeing the problem as one of affordability misses the fact that the means tests can be seen as a source of state revenue rather than a reduction in expenditure. The financial question is not one of affordability but of redistribution. The high rates of clawback - identified by the inequitable kink in figure 1 - create vertical inequality and perverse incentives - as demonstrated in table 1. Relatively simple tax changes can easily recover the loss of income arising from abolishing the means tests.

It is the mechanisms that are used rather than the redistribution question that create the most egregious problems. Three major offences against justice are the unwarranted interference in the lives of pensioners, the injustice of laws too complex to be correctly administered, and the deadweight costs to both the affected pensioners and the government of attempting to do so.

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The internal structure of government and an alignment of established interests make it difficult to achieve reform. Reform is not however impossible.

- Government needs to be persuaded that means tests and taxation should be considered together as a single policy issue. Means tests operated by different government departments and local governments, which can push marginal rates of clawback to over 100%, should be included.
- Those in the retirement industry who lobby for tax preferential treatment for contributions, without considering the needs of the means-tested, need to be corrected.
- Public interest groups need to be persuaded that focussing on the poorest may be too narrow.

There is a moral imperative for those with power. As the New International Version has it: 'speak up for those who cannot speak for themselves'.

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<sup>1</sup> Willmore (2001) reports that only 4 countries have universal non-means-tested schemes: New Zealand, Mauritius, Botswana and Namibia. Hancock *et al* (2005) say that 18 out of 30 OECD countries include a means tested component in their state systems. The rest offer a minimum pension from an otherwise earnings-related mandatory pension system.

<sup>2</sup> Page 1 with references to other studies removed.

<sup>3</sup> Principles for reform: the national pensions debate published by the Department of Pensions and Works ([dwp.gov.uk/publications/dwp/2005/pensions\\_debate/](http://dwp.gov.uk/publications/dwp/2005/pensions_debate/))

<sup>4</sup> AXA (2006) AXA Equitable Retirement Scope: Retirement — a new life after work? Report [axaonline.com/axa/pressroom/2006/2006\\_01\\_24\\_Retirement\\_Survey\\_International.pdf](http://axaonline.com/axa/pressroom/2006/2006_01_24_Retirement_Survey_International.pdf)

<sup>5</sup> Two working papers from the Centre for International Studies, University of Toronto illustrate this point. ([www.q-squared.ca/papers.html](http://www.q-squared.ca/papers.html))

Appleton S & D Booth (2005) Combining Participatory and Survey-based Approaches to Poverty Monitoring and Analysis

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<sup>6</sup> The detailed Financial Diaries survey of the expenditure habits of 150 poor families in South Africa found rural families spend 2.5% of their incomes on medical care, as against the 1% spent by wealthier urban families. See [www.financialdiaries.com/files/Financial%20Diaries%20Medical%20Focus%20Note.pdf](http://www.financialdiaries.com/files/Financial%20Diaries%20Medical%20Focus%20Note.pdf)

<sup>7</sup> Hausman and McPherson (1996,138) quoting Tawney (1931,139) *Equality* New York: Harcourt, Brace and Co.

<sup>8</sup>  $(1+(1-t)i)^n < 1+(1-t)\{(1+i)^n - 1\}$  for  $n > 1$ , tax at rate  $t$

<sup>9</sup> Information on these can be found at websites of the relevant government departments: [sassa.gov.za](http://sassa.gov.za), [centrelink.gov.au](http://centrelink.gov.au); [thepensionservice.gov.uk](http://thepensionservice.gov.uk). The first is however not yet fully operational.

<sup>10</sup> [finance.gov.za/](http://finance.gov.za/) and [budget2005.treasury.gov.uk/page\\_09.html](http://budget2005.treasury.gov.uk/page_09.html)

<sup>11</sup> Which can be found at [budget.gov.au/2005-06/bp1/html/index.htm](http://budget.gov.au/2005-06/bp1/html/index.htm)

<sup>12</sup> The present value of the state old age pension is more or less equal to the tax free lump sum. If a new pensioner's savings were three times the tax free lump sum then the means test would apply to two thirds of their retirement savings. This is where the affect of the means test is at its maximum, so the average must be less.

<sup>13</sup> For 30 years of Australian rates see <http://www.bendzulla.com/ref8.html>. South African changes will be found to be of the same order. The last 10 years have however been relatively stable and can be found at: <http://www.sars.gov.za/it/Income%20Tax%20Tables/Income%20Tax%20-%20Tax%20Rates-Duties-Levies%20-%202004.pdf>

<sup>14</sup> As, for instance, in Lundberg (2005)

<sup>15</sup> See particularly table 2.1 in the report, which can be found at: [anao.gov.au/WebSite.nsf/Publications/4A256AE90015F69BCA256B22000BE66B](http://anao.gov.au/WebSite.nsf/Publications/4A256AE90015F69BCA256B22000BE66B)

<sup>16</sup> Presentation by John Hills to the 2005 AGM of the Pensions Policy Institute [pensionspolicyinstitute.org.uk/uploadeddocuments/John\\_Hills\\_AGM\\_Slides\\_7\\_June05.pdf](http://pensionspolicyinstitute.org.uk/uploadeddocuments/John_Hills_AGM_Slides_7_June05.pdf)

<sup>17</sup> As for footnote 16.

<sup>18</sup> Of the 2 respondents out of 150 Financial Diaries families with unit trusts which could be presumed to offer comparable returns to retirement fund, one was a taxpayer (facing a marginal rate of 25%) the other not. Most families appear to have bank accounts which would have offered poor yields. Although informal loans to friends and family may have offered higher returns, this would have been at some risk. See <http://www.financialdiaries.com/files/Financial%20Diaries%20Financial%20Styles%20smaller.pdf>

<sup>19</sup> This is extrapolated from Smith (1995) and the South African budget reports on retirement fund tax.

<sup>20</sup> See Tax Expenditure Statement at [treasury.gov.au/documents/950/PDF/TES\\_2005.pdf](http://treasury.gov.au/documents/950/PDF/TES_2005.pdf)