CSRI
COMMITTEE FOR SUSTAINABLE
RETIREMENT INCOMES

Submission from the Committee for Sustainable Retirement Incomes

Inquiry into the Social Services Legislation Amendment (Fair and Sustainable Pensions Bill 2015)

15 June 2015

Contents

CSRI
COMMITTEE FOR SUSTAINABLE RETIREMENT INCOMES

Introduction

On 5 June 2015, the Secretary of the Senate's Community Affairs Committee, Jeanette Radcliffe, invited the Committee for Sustainable Retirement Incomes (CSRI), through its Executive Director (Ms Patricia Pascuzzo), to provide a written submission by 12 June to its Inquiry into the Social Services Legislation Amendment (Fair and Sustainable Pensions) Bill 2015.

This submission focuses on the proposed measures set out in the Bill to vary the pension assets test. It has been prepared by CSRI members Professor Andrew Podger, Dr Michael Keating and Ms Patricia Pascuzzo.

In the very short time available, the CSRI has not undertaken detailed analysis of the impact of the proposed measures but has relied mostly on the material presented by the Government and some recent analysis by the Tax and Transfers Policy Institute (TTPI) at the Australian National University (which the CSRI understands is providing its own submission to the Inquiry).

Background

The CSRI is an independent, non-partisan, non-profit organization committed to improving the adequacy and sustainability of retirement incomes of older Australians. It pursues its mission by acting as a catalyst for informed public debate, and the development of evidence-based policy and research.

The CSRI recognizes that the Australian system of retirement incomes has considerable strengths, but there are also significant weaknesses that need to be addressed to improve its effectiveness and sustainability.

To achieve this aim, the Committee adopts a highly consultative approach, actively seeking contributions from all stakeholder groups and encouraging different viewpoints to be heard, while subjecting these to careful evidence-based analysis.

The CSRI recently held a Leadership Forum in Canberra that brought together leaders in public policy, industry, community and academia. The purpose of the Forum was to stimulate debate and understanding of the issues surrounding the sustainability of the retirement income system with a view to finding common ground and identifying practical solutions. A communiqué was signed by:

- Academy of the Social Sciences of Australia (ASSA)
- Australian Council of Social Service (ACOSS)
- Council on the Ageing (COTA Australia)
- Industry Super Australia (ISA)
- National Seniors Australia (NSA), and
- Committee for Sustainable Retirement Incomes (CSRI).

One of the key concerns from the Forum was that constant piecemeal change and continual speculation around superannuation rules and age pension eligibility create great uncertainty for Australians in and nearing retirement. The absence of clear goals and objectives was identified as an inhibitor to the development of policies conducive to system stability and sustainability, as well as its efficiency and equity and to broad community confidence in its future. Further, in the absence of agreed objectives, and because of the continuing tinkering with the retirement incomes system, there are questions about the system's coherence and effectiveness and it is difficult to agree how it could be improved.

One of the key conclusions from the Forum was that Australia requires a whole-of-Government retirement income strategy that includes both the superannuation system and the age pension, and

CSRI
COMMITTEE FOR SUSTAINABLE RETIREMENT INCOMES

that encourages individuals to self-fund more of their retirement incomes and rely less heavily on future generations to meet the costs.

The Government's response to the Financial System Inquiry (FSI or Murray Inquiry) and the Review of Retirement Income Stream Regulation offer opportunities to progress work in a number of superannuation related areas in the near term. The Tax White Paper process now underway also offers scope to address related issues, particularly taxation of the superannuation system. What is missing is consensus on an overarching framework for the retirement income system as a whole – covering the age pension system, the superannuation system, related aspects of the tax system and other closely related matters such as the provision of appropriate housing for the aged, aged care, and the cost of health care for the aged. Given the significant interrelationships between the superannuation, age pension and taxation systems, the Leadership Forum considered that clear overarching objectives are needed for the whole retirement income system. Legislated goals and measurable objectives for the retirement income system would assist in providing a framework to guide coherent policy development.

The Leadership Forum was inclined to follow the lead of the Murray Inquiry and propose a limited number of core objectives for the retirement income system as a whole, supported by a number of principles that would guide progress towards the basic goals.

The core objectives the Leadership Forum suggested for the system are:

- First, to alleviate poverty in old age; and
- Second, to facilitate adequate living standards in and through retirement for all.

The age pension and superannuation work in combination to deliver these objectives. The primary objective of the age pension system is to ensure a modest standard of living consistent with social norms. The primary goal of the superannuation system is to facilitate the maintenance of adequate living standards in retirement. The CSRI has foreshadowed further work to define appropriate adequacy benchmarks.

Focussing on these two core objectives should temper suggestions that the system pursue other goals such as wealth creation, estate planning, increasing national savings or investment in infrastructure or non-retirement expenditures. This would also promote greater coherence between the age pension and superannuation arrangements and counter the simplistic view that the primary purpose of superannuation is to reduce the number of aged people accessing the age pension.

The two basic goals or objectives should be complemented by principles that enable the retirement income system's performance to be assessed. These principles could be:

- Broadness and adequacy – it should protect those unable to save against poverty in their old-age and provide the means by which individuals must or can save for their retirement;
- Fairness and acceptability - it should consider the income needs of individuals both before and after retirement, be equitable and not bias inappropriately other saving decisions;
- Robustness – it should deal appropriately with investment, inflation and longevity risk;
- Simplicity and certainty - it should allow individuals to make decisions with confidence that they are in their best long-term interests; and
- Sustainability – it should be financially sound and detract as little as possible from economic growth.

The Leadership Forum was of the view that a comprehensive review of the retirement income system against these objectives and principles is needed to identify priority areas for reform and develop a policy blueprint including a transition path for implementation.

Such a review would almost certainly identify reform priorities both in the age pension and the superannuation arrangements, not only in terms of containing outlays and tax expenditures, but also in terms of improving the effectiveness and cost-effectiveness of the system. As the FSI has highlighted, an important aspect is to ensure super savings (and the associated tax support) are used to deliver retirement incomes over people's full retirement years and are not directed unnecessarily or unintentionally to the next generation. Getting this right would not only enhance the effectiveness of the system as a whole but also take pressure off the age pension.

The CSRI is concerned that piecemeal approaches, such as the Government's focus on the age pension means test or the Opposition's focus on tax concessions, will only continue uncertainty about the retirement incomes system as a whole and introduce new complexities and unintended effects without achieving the claimed purpose of greater sustainability.

The design of the age pension system, particularly the arrangements for targeting payment, involves a trade off between targeting the payments to those with the greatest need while still providing an incentive for people to save towards their own retirement income and, where they have the means, to be fully self sufficient. Evaluation of any proposed changes to the system therefore relies on a judgement of whether the resulting balance between targeting and the provision of incentives are judged to be appropriate.

Age Pension Assets Test

General Reform Directions

The Government has noted that its proposals would involve a return to the asset test withdrawal rates that applied between 1994 and 2007. While this is true, it is not a return to a more coherent approach to means-testing but a reversal of more recent reform directions that would have offered the prospect of a more coherent approach better aligned to the emerging superannuation system.

There is a strong case, based on the objectives for the retirement incomes system suggested by the CSRI and consistent with the Murray FSI Report, to view superannuation savings in terms of the retirement income streams they can generate (not the accumulated savings), and to apply the age pension means test against those income streams. This would also be consistent with the age pension itself which is in the form of an income stream or lifetime annuity.

Building on the 2007 changes to the assets test (which reduced the withdrawal rate from $3 per fortnight per $1,000 of assets above a threshold to $1.50 a fortnight), it is noteworthy that the Henry and Harmer Reports in 2009 recommended the use of the income deeming system to convert assessable assets into equivalent income and subjecting that income (with any non-asset income) to the pension income test. Depending on the deeming rates chosen, the effect of this could be of a similar order of magnitude as the then assets test withdrawal rate ($1.50 a fortnight) but with a lower threshold. The Henry Report also advocated broadening the range of assets involved to include the home above a high threshold value.

Even if the home asset was not included, the Henry/Harmer Reports' approach would be likely to generate budgetary savings because the deeming would apply to the full amount of assessed assets (albeit with, as now, a lower rate for assets up to some low threshold and a higher rate for assets beyond that threshold). The savings could be significant if the deeming of superannuation savings incorporated, as it should, the expectation that the income stream should include return of capital as well as return on capital. (A deeming rate of close to 6% would reflect annuity values from assets at normal official interest rates which, given the 50% income test taper, would in effect be only slightly below the current assets test withdrawal rate of 3.9%). This approach is similar to the income test that applied in the 1960s and early 1970s where 10% of assessable assets were converted into income and added to any non-asset income. At that time this was broadly equivalent to the indexed annuity the assets could purchase given then prevailing life expectancies.

Designing Means Tests

It is unusual in designing any means test to specify the cut-out point where eligibility for any pension ceases as a central parameter. The cut-out point is a function of the maximum level of the pension and the withdrawal rate (and any 'free area'). The key policy focus is usually on these two parameters: the adequacy of the maximum pension in terms of alleviating poverty for those with no other means, and a rate of withdrawal which retains reasonable incentives to work and to save. The cut-out point emerges as a result, not normally as an initial policy parameter.

CSRI
COMMITTEE FOR SUSTAINABLE RETIREMENT INCOMES

The Government's proposal by contrast places most emphasis on the cut-out points in the assets test, and pays little attention to the possible adverse impact of the very high withdrawal rates on incentives to save and invest. Indeed, the significant increases in the assets test free areas that are proposed combined with the reduction in the cut-out points require a particularly high withdrawal rate (albeit one that has applied in the past). The following table summarises the proposed test given current pension rates.

Current and Proposed Asset Test Parameters

	Current free area ($,000)	Current cut-out point ($,000)	Current Taper ($pa per $1,000 assets)	Proposed free area ($,000)	Proposed cut-out point ($,000)	Proposed Taper ($pa per $1,000 assets)
Single Pensioner (non-home owner)	202	776	39.00	450	747	78.00
Single (home owner)	202	776	39.00	250	547	78.00
Pensioner Couple (non-home owner)	286.5	1,152.5	39.00	575	1,023	78.00
Couple (home owner)	286.5	1,152.5	39.00	375	823	78.00

As mentioned, the effect of the Henry and Harmer Reports' reform measures would almost certainly have been to effectively reduce the withdrawal rate under the assets test slightly further (not increase it), but to lower the assets test free area (not increase it).

The inconsistency between the current deeming rules (which are not proposed to be changed) and the proposed assets test can be illustrated by considering the impact of each for a home owner couple with $823,000 in assessable assets (the proposed asset test cut-out point) and no other income. Under the deeming rules they would be entitled to a combined pension of over $20,000 a year whereas under the assets test they would not be entitled to any. (Pensioners receive the lesser of their payment rates under the two tests.) For a couple with $390,000 in assets, the new assets test would have no effect though the deeming rules would kick in reducing their combined pension by around $2,000 a year.

Does this matter? We think it does because it demonstrates a lack of coherence in the means test arrangements and a lack of any common and considered approach to incentives or to what the overall system should be delivering in terms of 'adequate' retirement incomes.

Effective marginal and average tax rates

We understand the TTPI is providing some detailed analysis to illustrate the effective average and marginal tax rates implied by the Government's proposals.

The proposed withdrawal rate of $3 per fortnight per $1,000 above the free areas is equivalent to a marginal wealth tax of 7.8% ($78.00 a year per $1,000). Translating that into an effective marginal income tax rate depends upon the real interest being earned. At 6% real interest, the effective marginal income tax rate would be 130% (a 30% reduction in net income as a result of earning extra interest from the extra assets while preserving the real value of those assets); at 3% real interest, the rate would be 260% (ie the net income would fall by well over the extra interest earned).

Average effective tax rates will depend not only on the interest earned but also on the total assets involved because of the impact of the proposed free areas. But for those with assets around the cut-out points, the average effective tax rates with real interest of 6 or 3% would be between 50 and 260%, with rates almost always above 100% if the real interest earned is 3%. In other words, despite the couple having $823,000 earning real income of 3% (after preserving their real assets), their net income would be less than had they had no assets and relied entirely on the pension. The effective tax rates would vary with the level of interest and the level of assets, with lower rates where assets are nearer the proposed free areas ($375,000 for a couple).

In the current climate real interest rates of 3% are not easily achieved without significant risk, risks that people in the drawdown phase of superannuation should not generally be taking. There is therefore serious danger of the proposed test encouraging unwise investment behaviour.

Another incentive would be to shift a significant part of the assets into non-assessable assets such as the family home by repaying any outstanding mortgage; renovating or upgrading to a more expensive home. Shifting $100,000, for example, would allow a combined pension of $7,800, more than most might expect in interest on the assets involved.

It is hard to predict the impact on people's savings and investment behaviours as they approach age pension age, but the incentives do not seem consistent with those intended by the superannuation system.

Overall retirement income effects

As the Minister has mentioned, of course, this analysis of 'effective income tax rates' does not take into account that people should be drawing down their superannuation assets in their retirement to generate income streams that deliver adequate standards of living in retirement. The question is whether the drawdown implicit in the proposed test is reasonable. We believe it is not.

There are several ways to define 'adequate' retirement incomes. The Australian Superannuation Funds Association (ASFA) uses two benchmarks which are useful for general comparisons and analysis: a 'modest' standard that is almost exactly the current maximum level of the pension for those who own their own homes outright, and a 'comfortable' standard that is currently around $58,000 for a couple who own their own home outright. It seems reasonable to assume that ASFA would expect a home-owning couple with $823,000 of accumulated superannuation to be able to live 'comfortably' in retirement. But to consume $58,000 with assets of $823,000 would require the couple to rundown their assets by around $35,000 if they are earning 3% real interest, and more if earning less (which many may now be doing). Most likely this would entail a reduction in the monetary amount of their assets, not just in their real level of accumulated assets. Such a result may not be untoward if the couple are now in their 70s but would be of considerable concern if they are still in their 60s.

In other words, despite having saved $823,000 in superannuation, the couple could not expect to maintain a 'comfortable' retirement income for life, but would either run the risk of running out of savings or, more likely, choose to live more frugally than they might have reasonably expected.

It is this latter behaviour that the FSI was most concerned about, recommending reforms aimed to offer retired superannuants more secure and adequate incomes through better retirement income products. The proposed assets test does not appear consistent with the FSI's reform directions which favour converting assets into retirement income streams.

Should the couple, however, take the option to rundown their assets more quickly than might be wise in order to live 'comfortably', they would of course become eligible for some part pension as their assets fall below the cut-out points. In other words, the initial budgetary savings would be reduced slowly over time.

Many retirees now choose to drawdown income from their accumulated superannuation at the minimum rates required by the superannuation regulations. For a couple in their 60s with $823,000, the minimum drawdown is 4% or around $33,000, no more than the maximum rate of the pension. The Government has just confirmed it will not increase these requirements, yet the proposed assets test seems designed to require higher drawdowns as it is not intended to leave a couple with $823,000 with an income more than the pension. The Government should explain just what it expects retirees to do. In our view, it is not unreasonable for such a couple, that has foregone consumption to save for their retirement, to retain eligibility for a part pension which, combined with a reasonable drawdown of assets, would leave them with a secure and reasonable income significantly above the maximum rate of the age pension.

Home owners and renters

An interesting element in the Government's proposal is to set different free areas and cut-out points for home owners and non-home owners. This has some attraction in that it would recognise that home owners do have considerable additional assets which not only reduce their living costs but also provide an avenue to increase their retirement incomes and consumption (for example via reverse mortgages) if they so choose. In a sense it is an alternative to the Henry proposal to include home assets in the means test subject to a significant threshold.

On balance, we would prefer the approach of the Henry Report which would more directly address the issue, noting however that there are separate proposals from the Productivity Commission to draw on home assets to finance more of our increasing aged care costs. There are obviously limits to the extent we might expect home assets to be used to finance different social services.

We also note that the Henry and Harmer Reports also both proposed that priority be given to increasing rent assistance to directly assist those most in need of support. The Government's proposals do not address this issue.

Broader Reform Directions

As mentioned, the CSRI considers that a more holistic approach is needed to reform our retirement incomes system and that this needs to be guided by an agreed set of objectives and supporting principles.

The Leadership Forum recommended that a comprehensive review could consider the following issues:

- Factors that affect gainful employment, the implications for age of access to the pension and superannuation benefits, and measures to allow individuals to better transition from work to retirement.
- Improving the efficiency of the safety net including the relationships between savings, age pension eligibility and home ownership.
- The adequacy of the age pension and superannuation pensions when the present scheme matures, and the interaction with other elements of the welfare system including health, aged care, rental housing and public housing.
- The effectiveness, efficiency and fairness of the tax concessions for superannuation saving, much of which is compulsory.

- The extent to which it should be a requirement to use superannuation payments to generate a retirement income, and how the longevity risk of living longer than expected can best be handled.
- Transitional arrangements while the superannuation system will continue to mature over another twenty years.

Conclusion

The CSRI believes a more comprehensive review of the system could deliver budgetary savings over time, including from the age pension, while providing more adequate and secure retirement incomes. In the meantime, it does not support this assets test proposal nor the Opposition's proposals regarding superannuation.