Australian
Council of
Social Service

Submission to the Taxation Review Panel

Adequate, fair, sustainable, and simple: Retirement incomes reform

ACOSS, February 2009

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Summary

ACOSS welcomes this review of public support for retirement incomes. Despite substantial changes over the past two decades, including the introduction of the superannuation guarantee and major changes to the age pension and the tax treatment of superannuation, the system as a whole has not been comprehensively reviewed.

It is important to do so at this time. In 40 years, there will be 5 people of working age for every 2 mature age people, down from a ratio of 5 to 1 at the present time. We need to ensure that the growing number of mature age Australians can live decently, that the cost of public income supports is sustainable, that people understand and can engage with the system, and that social inequality in retirement is contained.

This submission advocates reforms to pensions, superannuation, and tax concessions for retirement, to be implemented in three steps.

The first step is to announce in this year's Federal Budget increases in the single rate of pensions and unemployment allowance payments, together with a general increase in Rent Assistance, to ease the financial hardship facing these social security recipients.

- The single pension rate should be lifted to two thirds of the partnered rate, which would also meet the cost of a 'low cost budget' that is sufficient to avoid poverty (an increase of approximately $28 per week), unemployment allowances should be increased by $30 per week to begin to close the $56 gap between these payments, and Rent Assistance should be increased by 30% or an average of $15 per week.

The second step, to be implemented once the economy recovers from its present downturn, should partly offset the cost of the increases in pensions described above, and be linked legislatively to those increases. It should include a modest increase in the taper rate for the pension income test to target payments to those most in need, and abolition of the Senior Australians and Mature Age Workers tax offsets (SATO and MAWTO).

- The pension income test taper rate should be progressively raised from 40 cents in the dollar to up to 50 cents in the dollar, and the SATO and MAWTO would be abolished.

Third, a set of structural changes to the retirement incomes system would be implemented over a longer time frame, following community consultation. These measures would be underpinned by a set of retirement income targets.

- The present tax concessions for superannuation contributions would be replaced by a simpler and fairer Government co-contribution for all contributions made up to an annual ceiling.

Other reforms include a progressive increase in the preservation age for superannuation to equal the pension age (which would remain at 65 years), a redesigned pensions income test to remove the need for pensioners to pay income tax, simplification of the treatment of income from investments by extending the present 'deeming' arrangements, and the progressive introduction of a health and aged care income tax levy to assist with higher health care costs as the population ages.

Directions for reform

Our policy recommendations are detailed below, under four headings:

- *adequate* incomes
- *equitable and efficient* tax concessions for superannuation
- a *sustainable* social security and tax system for mature age Australians
- a *simpler* system for mature age Australians.

1. Adequate

All social security payments should be progressively lifted above an official 'Australian Minimum Standard of Living'. Research on living standards demonstrates that in addition to many single pensioners, high proportions of unemployed people, sole parents, people with disabilities, and low income tenants, regularly go without essentials like a decent and secure home and dental treatment.

At just $281 per week, or 60% of the amount paid to a couple, the maximum single rate of age pension is inadequate to meet even very basic living expenses, even when the standard supplements (Utilities Allowance, Pharmaceutical Allowance and Telephone Allowance), which are worth about another $15, are added in. For example, it is around $20-$25 per week below the austere 'Low Cost Budget' for retired home-owners developed by the Social Policy Research Centre. Further, overseas social security systems typically pay a single adult at least two thirds of the pension for a married couple (which would be about $28 per week higher than the present payments for singles). At just $225 per week, the single rate of Newstart Allowance for unemployed people is almost $60 per week less than the pension. The growing gap between these payments is unfair, and discourages people on pension payments like Disability Support Pension from seeking employment.

ACOSS proposes an adequacy target for all social security payments. All social security payments should be raised above an Australian Minimum Standard of Living. This would be a poverty standard, possibly based on the abovementioned Low Cost Budgets.

In addition, two broader targets for retirement incomes are proposed – to be achieved through a combination of retirement incomes from age pensions and superannuation. The first of these targets would be based on the maintenance of typical pre-retirement living standards. Once the superannuation guarantee matures (and most employees have received 9% of earnings in superannuation accounts throughout working life), a typical employed household should enjoy broadly the same overall living standard in retirement as throughout working life, taking account of the lower costs faced by most retirees (especially the costs of children and housing). This reflects the basic goal of retirement saving, to smooth incomes between working age and retirement.

The second of these targets is that the age pension and superannuation should together provide enough income to fund at least a 'modest but adequate' retirement budget, well above poverty levels, for the vast majority of Australians. For example, the Social Policy Research Centre's Modest but Adequate Budgets for retired home owners are currently around $390 per week for singles and $540 per week for couples. This will be difficult to achieve for the 30-40% of future retirees who are projected by the Treasury to have very

limited superannuation, and to rely on the full rate of pension well into the future. Women, people with disabilities, and low skilled workers are over-represented in this group, who are unable to accumulate 30 to 40 years of fulltime paid employment. One policy option to help achieve this target is to transfer part of the public resources now devoted to tax concessions for superannuation and mature age Australians generally, towards a modest age pension supplement that is paid to all retirees regardless of income.

Recommendation 1:

(i) The base rates of social security payments for adults should be lifted to an Australian Minimum Standard of Living – the minimum income levels required by single adults and couples respectively to avoid poverty.

One possible benchmark for the base rate of payment for single adults would be the Social Policy Research Centre's Low Cost Budget Standard for a mature age home-owner, since this group does not face the extra costs associated with renting or workforce participation (costs which would more appropriately be addressed through supplementary payments). [1]

(ii) The single base rate should be indexed to a typical level of fulltime earnings, for example median fulltime earnings.[2]

(iii) The single rate should equal two thirds of the married couple rate.

Recommendation 2:

(i) The maximum single rate of all pension payments, including Age and Veteran's pensions, Parenting Payment Single, Disability Support Pension and Carer Payment, should be raised from July 2009 to reach the benchmarks in Recommendation 1.

Raising the single rate to two thirds of the couple rate would require an increase of approximately $28 per week, which would exceed the Low Cost Budget Standard and be equivalent to approximately 30% of median fulltime earnings.

(ii) The Utilities Allowance, Pharmaceutical Allowance and Telephone Allowance should be included in the new base rates of payment.

(iii) Maximum rates of Rent Assistance should be increased by 30% for all recipients, whether pensioners, allowees or families. This is an average increase of approximately $15 per week for social security recipients renting privately.

Recommendation 3:

(i) As a first step towards removing the gap between pensions and allowance payments for people of working age, the maximum single rates of Allowance payments should be increased by $30 per week.

(ii) At the least, the gap between pensions and allowance levels should not widen as a result of these reforms.

[1] Its current value is approximately $305 per week.
[2] In August 2007, this was $940 per week. Its current value would be slightly above $1,000.

Recommendation 4:

The Government would set national targets for income replacement in retirement in consultation with relevant stakeholders, based on:

(i) attainment of a living standard through retirement broadly equivalent to that achieved through working life, taking account of the lower living costs in retirement;

(ii) a typical income profile through working life (for example the equivalent of median fulltime earnings over 30-40 years);

(iii) a limited range of family types;

(iv) a fully matured superannuation guarantee scheme.

Recommendation 5:

(i) A supplementary target would be set to ensure that the vast majority of retired Australians can attain at least a 'modest but adequate' income benchmark, significantly above poverty levels, from a combination of age pensions and superannuation benefits once the superannuation guarantee matures.[3]

(ii) To assist people with low superannuation benefits to reach this target, a modest retirement income supplement could be paid as a universal component of the age pension (regardless of individual and household income levels). This could be financed by removing a range of tax concessions for mature age people (as proposed in Recommendation 9 below) or by reducing the cost of superannuation tax concessions.

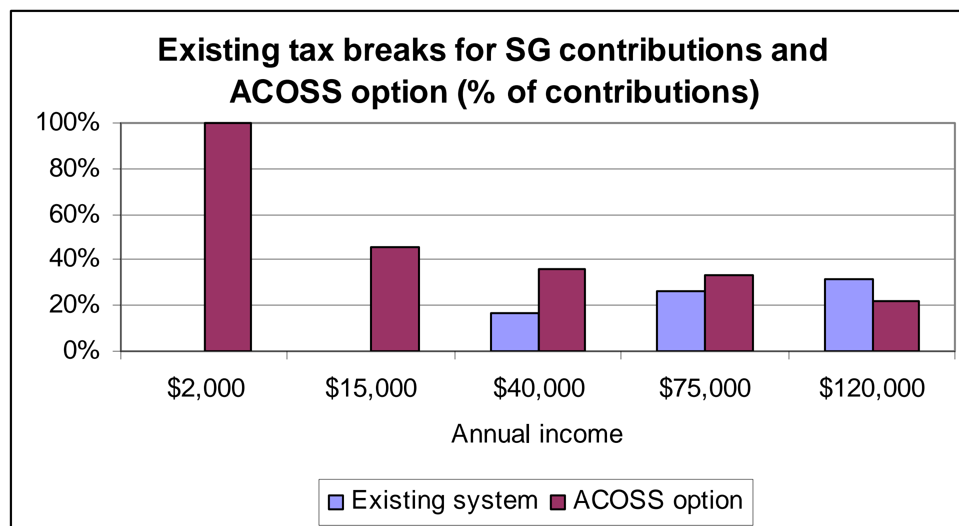
(iii) A further option to address investment risk, especially for low income earners with savings in multiple funds, would be to establish a publicly run safety net superannuation fund. Lost superannuation accounts could also be transferred to this fund.

2. Equitable and efficient

In 2006-07, tax concessions for superannuation cost $30 billion, slightly above the $26 billion annual bill for age and veterans pensions. Over half the $10 billion in annual tax breaks for contributions to superannuation go to the top 5% of workers, those on around $100,000 or above. One of the main reasons for this is that contributions made by employers are taxed at a flat rate of 15% instead of the marginal tax rate that would normally apply to their employee's wages. This means that many low income employees receive no discount on their income tax for employer contributions, while a high income earner typically saves over 30 cents in tax for every dollar contributed. This is inefficient as well as unfair because high income earners are likely to save for their retirement regardless of tax concessions. If the current tax breaks for contributions were replaced by a simple Government co-contribution for every dollar contributed to superannuation from all sources up to an annual ceiling, it could provide a similar boost to the retirement incomes of typical low and middle income earners to a 2-3% increase in superannuation guarantee contributions.

[3] These benchmarks are currently approximately $390pw for a single retired home-owner and $540 for a couple.

This is illustrated in the graph below, which compares the present tax treatment of superannuation guarantee contributions with an illustrative option for the proposed co-contribution - a dollar for dollar co-contribution for contributions up to $300 per year (0.5% of AWE) plus 30% of all additional contributions up to $7,000 (12% of AWE). This change would benefit the vast majority of employees, yet because such a high proportion of existing tax breaks go to the top 5% it would be broadly revenue-neutral.



Recommendation 6:

The taxation of superannuation contributions would be simplified and made fairer by:

(i) ensuring that all contributions are made from after-tax income by taxing employer contributions in the hands of the employer at marginal rates of personal income tax, and removing the 15% tax for employer contributions;

(ii) replacing all present tax concessions for contributions and Government co-contributions (including deductions for self employed individuals and the tax offset for spouse contributions, but not the Fringe Benefits Tax exemption for employer contributions) with a simple two tier co-contribution or tax offset for all contributions made in respect of an individual up to an annual ceiling (whether compulsory or voluntary), which would be paid annually into the fund.

Recommendation 7:

An alternative option to Recommendation 6 is to tax annual accumulations in superannuation accounts (both contributions and fund earnings) at each fund member's marginal rate of personal income tax:

(i) a co-contribution or tax offset similar to that proposed in Recommendation 6 would be paid annually into the fund.

3. Sustainable

Although the Australian age pension system is cost effective by international standards, health and aged care costs are projected to rise substantially as the population ages. At present only one in five individuals over 64 years of age pays income tax. Yet in 20 years time it is estimated that almost half of all household wealth will be held by people over 64 years of age.

Steps should be taken in the near future to ensure that sufficient revenue is collected to meet the costs of an ageing population, and that the proposed increases in age pension levels are affordable over the long term. This includes a modest tightening of the pension income test. A couple can now receive almost $70,000 in annual income and still qualify for a part pension under the income test. Tax offsets based on age alone are inequitable and costly. For example the Senior Australians Tax Offset costs over $1 billion each year and benefits retirees who are relatively well off. It results in a combined effective tax free threshold for a retired couple of almost $50,000 compared with $30,000 for a couple of working age.

Mature age people can presently ‘churn’ their earnings and investment income through their superannuation accounts in order to reduce their income tax. For example, a wage earner on $100,000 who sacrifices half their salary to superannuation, and is then paid a superannuation pension to replace the lost earnings, saves around $11,000 in tax without adding to their overall retirement savings. This practice is costing the Government billions of dollars in uncollected tax revenue. The tax rules for superannuation should be tightened to ensure that tax breaks are only available for their original purpose, to save for retirement. This would include a requirement that individuals over 65 years of age draw down their superannuation assets progressively throughout retirement.

To keep the economy growing and to fund essential services as the population ages, it is vital that more mature age people retire later, and retire gradually (by working on a part time or temporary basis after leaving their fulltime jobs). The most important step that policy makers could take to encourage people to do this is to raise the preservation age for access to superannuation from 55 years to the pension age of 65 years. This would be phased in gradually. It would be much fairer and cause less financial hardship than an increase in the pension age itself, since the people who rely most on the age pension are those who have little choice but to retire at 65 or earlier – such as people with disabilities or caring responsibilities and low skilled workers who have been made redundant. These people typically derive little benefit from early access to superannuation because the balances in their superannuation accounts are only small.

One way to ensure that Governments have sufficient revenue in future to fund basic health and aged care services for all Australians is to progressively introduce a health and aged care income tax levy as the population ages, and the cost of these services rise. This could be based on a redesigned Medicare Levy. So that mature age people make a fair contribution to meeting these rising health and aged care costs, the levy would apply to income of individuals over 64 years of age (above the low income threshold) regardless of any remaining age or retirement-specific tax offsets.

Recommendation 8:

In conjunction with the increase in the maximum rate of pension proposed in Recommendation 2, the taper rate on the income test for the maximum rate of age pension would be raised above its present level of 40%, to up to 50%. This would be introduced progressively after the economy recovers from the present downturn.

Recommendation 9:

Age-specific tax concessions for mature age people including the Senior Australians Tax Offset and Mature Age Workers Tax Offset would be abolished, after the economy recovers from the present downturn.

Recommendation 10:

The preservation age for superannuation benefits would be progressively raised to equal the pension age – which will eventually be 65 years for both men and women - subject to the following conditions:[4]

(i) Individuals who have disabilities that would qualify them for the Disability Support Pension or caring responsibilities that would qualify them for Carer Payment (as assessed by Centrelink for this purpose) would be able to draw down their benefits from age 55, regardless of their income and asset levels;

(ii) If compulsory saving levels are raised beyond 9% of earnings, individuals would be able to draw down a portion of their superannuation assets before they reach preservation age, subject to a saving requirement of at least five years and a fixed lifetime ceiling on such withdrawals, either for any purpose or for a fixed set of purposes (such as education, child rearing, or housing), and then for any purpose after 55 years.[5]

Recommendation 11:

The age at which superannuation benefits from taxed sources become tax free would be raised from 60 to 65 years in line with the proposed increases in the preservation age.

Recommendation 12:

Contributions to superannuation beyond preservation age would only attract the Government co-contribution or tax offset proposed in Recommendation 6 in respect of a year in which an individual's total contributions received exceed total superannuation benefits paid.

[4] The target for the pension age should remain at 65 years.
[5] ACOSS has previously proposed broadening the purpose of superannuation beyond saving for retirement, within strict limits.

Recommendation 13:

Contributions to and investment income from superannuation accounts beyond the preservation age would only attract concessional tax and pension income test treatment where the account complies with a simple set of rules to ensure that the assets are progressively drawn down towards zero throughout retirement:

(i) This could also be achieved in part through the deemed income rules proposed in Recommendation 19.

(ii) Alternately, these draw-down rules could be applied to all superannuation accounts by regulation.

Recommendation 14:

Subject to implementation of the previous two recommendations, age and work-based rules restricting further contributions to and withdrawals from superannuation accounts would be eased for individuals aged 65 to 74 years. The present limits on contributions and the requirement to commence paying benefits once an individual reaches 75 years of age would remain.

Recommendation 15:

Superannuation benefits transferred to a non-dependent following the death of the member (excluding former partners) would be taxed at 30%.

Recommendation 16:

(i) As the proportion of the Australian population aged over 64 years increases, a health and aged care levy would be progressively introduced to help finance the additional health and aged care expenses.

(ii) The levy would apply to the taxable income of all taxpayers (subject to a low-income threshold), possibly as an extension of the existing Medicare Levy.

(iii) So that mature age people make a fair contribution to meeting these rising health and aged care costs, the levy would apply to income of individuals over 64 years of age (above the low income threshold) regardless of any remaining age or retirement-specific tax offsets.

4. Simpler

Age pensioners must deal with the complexities of pension income and assets tests as well as the income tax system, even though in most cases their financial affairs are relatively straightforward. It should be possible to collect a similar level of tax revenue from pensioners in a much simpler way by using the pension income test to collect income tax. The system could then be simplified further by extending the pension ‘deeming’ arrangements to deal with most superannuation assets and remove the need for annual accounting of income from that source. The deeming system could also be adjusted to take account of capital gains, removing the need for many pensioners to pay Capital Gains Tax.

Recommendation 17:

Subject to implementation of Recommendation 8, the tax-transfer system would be simplified for age pensioners subject to the income test, by integrating payment of income tax into the income test:

(i) This could be achieved by adding a standard income tax component (at a single rate or stepped rates, including the health and aged care levy in Recommendation 16) to the pension income test taper rate.

(ii) The income test for couples would need to be restructured so that it more closely resembles the treatment of individual income in the income tax system, for example by taking account of each individual's personal income first, and then that of their partner (as applies in the income test for Allowance payments).

(iii) Mechanisms would be needed to smooth transitions between the new income test and the income tax system for individuals over 64 years who move on or off the pension in a given year, and to prevent inequities and tax avoidance opportunities that may otherwise emerge.

Recommendation 18:

Whether or not Recommendation 17 is pursued, the definitions of income in the pension and income tax systems would be brought into closer alignment, based as far as practicable on the simpler and more robust pension definitions.

Recommendation 19:

As far as practicable, standard rates of return would be deemed on investment assets held by age pensioners for income test purposes:

(i) There would be at least two deemed rates of return based on typical risk-free investment returns for different levels of asset holdings, as there is at present.

(ii) Superannuation assets would be treated separately, and deemed to generate income over the expected lifetime of the individual.

(iii) The overall net value of financial (relatively liquid) assets held in respect of an individual (after taking account of any related debt) could be calculated in order to deem an annual rate of return on those assets. Alternately, different deeming rates could apply to different classes of assets.

(iv) Non-financial assets such as real estate could either be subject to the rules outlined in (iii) above, or else the existing pension income test treatment of these investments could be retained.

(v) In cases where annual valuation of investment assets is not feasible, capital gains from these assets could either be deemed on the basis of typical annual gains for each class of asset, or taken into account on realisation (when the asset is sold). If the latter option is pursued, consideration could be given to applying a standard interest charge to offset the benefits of deferred accounting for capital gains.

Recommendation 20:

As part of these simplification reforms, the separate pension income and assets tests could be replaced by a single income test incorporating the deeming rules for investment assets in Recommendation 19:

(i) If this is implemented, then separate income test free thresholds could apply to the investment income of home owners and non-home owners respectively, as is presently the case with the pension assets test.

1. Adequate

This part of the submission considers the adequacy of retirement incomes from three perspectives: prevention of poverty, earnings replacement, and a minimum living standard above poverty levels.

The three tiers of Australia's system of public support for retirement incomes are currently designed around the first two of these goals:

- the age pension provides a minimum income 'floor' for people on low incomes
- compulsory superannuation replaces a proportion of previous earnings
- tax concessions for voluntary retirement assist people to achieve higher rates of income replacement than though compulsory superannuation alone.

To prevent poverty

There are two ways of determining whether retirement incomes are adequate – by setting a minimum income standard for all (which could either be a poverty or 'minimum income' standard or a higher 'modest but adequate' standard), and by comparing people's incomes in retirement with their typical earnings during working life (income replacement).

Since the most important role for the age pension is to prevent poverty in old age, a minimum income or poverty benchmark is appropriate for setting pension levels. Table 1 compares base rates of age pensions with a set of standard minimum or Low Cost household budgets developed for mature age home-owners by the Social Policy Research Centre and a commonly used poverty line.

Table 1: Pensions and Allowances compared with Low Cost Budget Standards and poverty lines (dollars per week)

	Income support, excluding supplements (2007)	Low Cost Budget Standards (2007)	Poverty Line: 50% of median income (2006)
Single, mature age home owner (Age pension)	$269	$285	$281
Couple, mature age home owner (Age Pension)	$449	$390	$421
Single, unemployed (Newstart Allowance)	$215	$285	$281
Couple, unemployed (Newstart Allowance)	$389	$390	$421

Sources: Saunders 2004, *Updating and extending indicative budget standards for older Australians*, SPRC; Saunders 2004, *Updating budget standards for Australia;* Australia Fair 2007, *Update on those missing out* (www.australiafair.org.au).
Note: Budget standards are for mature age home owners. Poverty line estimates are for 2006, one year prior to the pension levels indicated in the table. These poverty lines would have increased by 2007.

The single pension rate consistently falls well short of these benchmarks. This suggests that any increase in social security payments should give priority to single people. The ratio between single and couple rates of payment in the Australian social security system (6:10) is lower than in most OECD countries. [6]

Another way to measure living standards is to ask people what they regard as the essentials of life, and whether or not they can afford those items. A recent research report published by ACOSS that uses this approach finds that the mature age people most likely to go without essentials are those who rent their housing (table 2). Likely reasons for this include the high cost of rent, and that home ownership is a proxy for access to other assets (such as financial assets) that shield people from poverty in retirement. The report also supports the view that on average, single pensioners are worse off than couples.[7]

Table 2: Multiple deprivation among mature age people and other households (2006)

Household type (mature age)	% with multiple deprivation	Household type (other groups)	% with multiple deprivation
Over 64 years (all)	12%	All households	19%
Over 64 (renting)	39%	Indigenous people	65%
Over 64 (single)	19%	Unemployed people	54%
Over 64 (couple)	8%	Tenants	53%
Over 64 (income less than $500pw)	12%	Sole parents	49%
Over 64 (income over $700pw)	3%	People with disabilities	27%

Source: ACOSS 2008, *Who is missing out?* See www.acoss.org.au.
Note: Multiple deprivation refers to lacking at least three out of a list of 26 essential items.

As table 2 indicates, age pensioners are not the only social security recipients living below what the community is likely to regard as an adequate living standard. The Newstart Allowance for unemployed people, and Austudy Payment or Youth Allowance for young people and adult students, are set at $56 and $126 per week below single pension levels respectively. These groups are much less likely than age pensioners to have significant assets such as a home that is fully paid off. Among social security recipients, the above ACOSS research report found that those at greatest risk of hardship were unemployed people, sole parents, and people on disability pensions. Any consideration of the adequacy of age pensions should therefore take account of other social security payments. It would be unfair to exclude these groups from any increase in payments extended to pensioners. The growing gap between pension and allowance payments also complicates the social security system and discourages workforce participation among people with disabilities and

[6] FAHCSIA 2008, *Pension review background paper.*
[7] ACOSS 2008, *Who is missing out?*

sole parents.

The single pension rate is presently benchmarked to an arbitrary percentage (25%) of average male fulltime earnings. The evidence from Budget Standards and other poverty research suggests that this income level is not adequate, at least for single mature age people. Further, a benchmark based on average male earnings is arguably inappropriate because the average is strongly influenced by income levels at the top and bottom of the distribution. It would be more appropriate to benchmark social security payments to typical, or median, levels of income across the community. The current benchmark also wrongly assumes that the typical employee is a man.

The research evidence suggests that social security recipients, including age pensioners, who rent privately face a particularly high risk of financial hardship. For example, 65% of private tenants in the bottom 40% of the income distribution spend more than 30% of their income on rent. This is a standard measure of housing stress. At $55 per week for a single adult, Rent Assistance only covers a small proportion of typical private rents today. A substantial increase in Rent Assistance would be particularly well targeted towards those social security recipients in the greatest hardship.[8]

Supplementary payments such as Rent Assistance, Carer Allowance and Mobility Allowance are targeted towards expenses faced by particular groups of low income earners that cannot readily be covered by base rates of payment. In the case of Rent Assistance, this is because housing costs vary substantially among different household types and regions and this has a major impact on living costs. Without Rent Assistance, base rates of social security payments would have to be much higher to prevent poverty among those who cannot avoid paying high levels of rent. Similarly, people with disabilities and carers face unusually large and unavoidable expenses that cannot readily be incorporated into base rates of payment for everyone.

On the other hand, Utility Allowance, Telephone Allowance and Pharmaceutical Allowance deal with expenses that are common to most social security recipients. It would be simpler to incorporate these supplements into base rates of payment at some stage.

Recommendation 1:

(i) The base rates of social security payments for adults should be lifted to an Australian Minimum Standard of Living – the minimum income levels required by single adults and couples respectively to avoid poverty.

One possible benchmark for the base rate of payment for single adults would be the Social Policy Research Centre's Low Cost Budget Standard for a mature age home-owner, since this group does not face the extra costs associated with renting or workforce participation (costs which would more appropriately be addressed through supplementary payments). [9]

(ii) The single base rate should be indexed to a typical level of fulltime earnings, for example median fulltime earnings.[10]

(iii) The single rate should equal two thirds of the married couple rate.

[8] Yates 2007, *Housing affordability and rental stress*, AHURI.
[9] Its current value is approximately $305 per week.
[10] In August 2007, this was $940 per week. Its current value would be slightly above $1,000.

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(i) The maximum single rate of all pension payments, including Age and Veteran's pensions, Parenting Payment Single, Disability Support Pension and Carer Payment, should be raised from July 2009 to reach the benchmarks in Recommendation 1.

Raising the single rate to two thirds of the couple rate would require an increase of approximately $28 per week, which would exceed the Low Cost Budget Standard and be equivalent to approximately 30% of median fulltime earnings.

(ii) The Utilities Allowance, Pharmaceutical Allowance and Telephone Allowance should be included in the new base rates of payment.

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Recommendation 3:

(i) As a first step towards removing the gap between pensions and allowance payments for people of working age, the maximum single rates of Allowance payments should be increased by $30 per week.

(ii) At the least, the gap between pensions and allowance levels should not widen as a result of these reforms.

To replace earnings

Another key measure of adequacy is income replacement. This is an appropriate benchmark for determining the level of the superannuation guarantee and the level and targeting of tax concessions for superannuation. The reason for this is that the basic purpose of the present superannuation system is to smooth incomes between one stage of life (working age) and another (mature age).

There is no official target for income replacement through compulsory superannuation, though a range of targets have been advocated by different organisations. Such a target would help inform policy development, given the vigorous debate over whether the superannuation guarantee should be increased above 9%. The basic principle in setting such a target should be to ensure that typical households can achieve the same or similar standard of living in retirement to that which they enjoyed (on average) through working life. A higher target than this for compulsory saving would not be appropriate, since people would be forced to save to achieve a higher living standard in future than that which they enjoy now. A much lower target may not be appropriate either, because overall community living standards increase substantially over the 40 years or so between the onset of working life and retirement, so there is a risk that such a target would leave retired people with a much lower living standard than the rest of the community.

To put this principle into practice, a retirement income target should take account of people's capacity to spend and their relative expenditure needs in retirement, compared with those during working life. This idea is much simpler to express than it is to put into practice.

A retirement incomes target based on a proportion of gross wages and superannuation payments alone is not appropriate for this purpose. 'Capacity to spend' should include age pension entitlements and income tax liabilities as well as superannuation benefits. Account should also be taken of people's capacity to draw down the capital component of their superannuation assets, since their purpose is to support people's retirement incomes rather than their children's inheritance. The 'expenditure replacement rate' developed within the Treasury is an example of this kind of measure.[11]

Using this measure, researchers from the Treasury estimated that once the superannuation guarantee matures in about 25 years' time, a median (middle) income earner will retain approximately 85% of their pre-retirement spending power over the first five years after retirement. This estimate was based on actual saving levels across the population, including non-compulsory saving, though most saving occurs through the superannuation guarantee. This was then assessed as adequate on the grounds that typical expenses after retirement are significantly lower than those throughout working life.[12]

The difference in expenditure needs between working age and retirement should be taken into account explicitly when setting a target for income replacement. Income or expenditure alone do not reflect people's actual living standards. For example, the costs of housing and child rearing are typically much lower in retirement than they are throughout working life.

NATSEM has undertaken research to compare typical living standards pre and pos-retirement for people who receive compulsory superannuation contributions throughout working life. This research is grounded in the Social Policy Research Centre's 'Modest but Adequate' budget standard, which measure the costs of a 'basic' basket of goods and services required by typical households before and after retirement. Unlike the 'Low Cost' budget standard described above, the Modest but Adequate standard is significantly above poverty levels. It is close to median household expenditure levels across the community (including all social security recipients and wage earners).

The NATSEM research involved three steps:[13]

- First, the after-tax incomes of typical low, middle and high income households were compared with these Budget Standards. For example, the after-tax income of a typical low income single woman of working age was equal to 115% of the cost of the Modest but Adequate Budget for a single female of working age.

- Second, the after-tax retirement incomes obtained from compulsory superannuation together with the age pension were compared with the relevant Budget Standards for retired people. For example, the after-tax income during retirement of a low income single woman who received compulsory superannuation throughout working life was estimated to be equal to 112% of the cost of the Modest But Adequate Budget for a single retired female home-owner.

- Third, these living standards before and after retirement were compared. For example, the single female in this case could afford 112% of a Modest but Adequate budget during retirement compared with 115% during working life. Thus, she can afford 97% of the living standard that she had during working life.

[11] Rothman 2007, *The adequacy of Australian retirement income*, RIM Unit Dept. of the Treasury.
[12] Rothman 2007, ibid.
[13] CPA Australia 2007, *Superannuation – the right balance?.*

Importantly, this research takes account of changes in the costs of housing and children (if any) before and after retirement. Table 3 below presents the basic results of this research for different types of households before and after retirement.

Table 3: Spending capacity before and after retirement for people receiving superannuation guarantee contributions only. (as a percentage of the cost of a 'modest but adequate' budget)

	Living standard during working life (as a % of MBA Budget)	Living standard during retirement (as a % of MBA Budget)	Living standard after retirement as a % of that before retirement
Single male			
- low income	127%	116%	92%
- middle income	174%	132%	*76%*
- high income	246%	156%	64%
Single female			
- low income	115%	112%	98%
- middle income	156%	126%	*81%*
- high income	219%	141%	65%
Couple without children			
- low income	164%	134%	82%
- middle income	229%	153%	*67%*
- high income	319%	183%	57%
Couple with 2 children			
- low income	96%	132%	137%
- middle income	125%	150%	*120%*
- high income	170%	171%	101%

Source: CPA Australia 2007, *Superannuation – the right balance?*
Note: Assumes employer superannuation contributions worth 9% of earnings are made through a working life of 40 years (only 26 years fulltime in the case of married women with children). Takes account of age pensions and the cost of housing, assuming full home ownership on retirement. 'Low', 'middle' and 'high' incomes refer to the average earnings of these individuals during working life.

An important conclusion from this research is that in all of the cases modelled, including the low income households, the household achieves more than a 'modest but adequate' living standard in retirement.

The figures in italics in the final column of table 3 are broad measures of income replacement in retirement for typical households on middle incomes. These replacement ratios range from 67% of pre-retirement spending capacity for a middle income couple without children to 120% for a middle income couple with 2 children. In other words, a middle income couple with two children receiving superannuation guarantee contributions through working life can attain a living standard throughout retirement that is 20% higher than that which they had when they were employed. Clearly a major factor here is the cost of children.

A national target for income replacement in retirement should be as simple and comprehensible as possible. The best way to achieve this is to use a small number of

typical examples, as in the research referred to above. Outcomes for people whose circumstances are not 'typical' can then be compared with these benchmarks.

One problem with the NATSEM approach is that an income replacement target based on the capacity to afford a basket of goods and services is more difficult to measure, update, and understand than one based on income or 'capacity to spend' alone. However, research along these lines could be used to develop a retirement incomes target (or a set of targets for a limited number of different household types) based on a simpler measure of spending capacity such as that developed by the Treasury. For example, the 'expenditure replacement rate' that corresponds to a replacement rate of 100% in the NATSEM modelling could be calculated. Given the lower cost of living of most retirees, this figure would be significantly less than 100%.

While targets for income replacement in retirement should be based on the circumstances of typical middle income households, public policy should also be concerned about income inequality in retirement. For this reason, a replacement income target should not apply to people on high incomes. They are capable of saving to achieve an adequate replacement rate without a high level of government support.

Conversely, many low income earners could achieve high income replacement levels in retirement but still have inadequate incomes. To address this problem, a 'modest' retirement income target significantly above poverty levels should be set, and public policy should aim to raise the vast majority of mature age people above that income level.

To extend a minimum living standard above poverty levels to more retired people

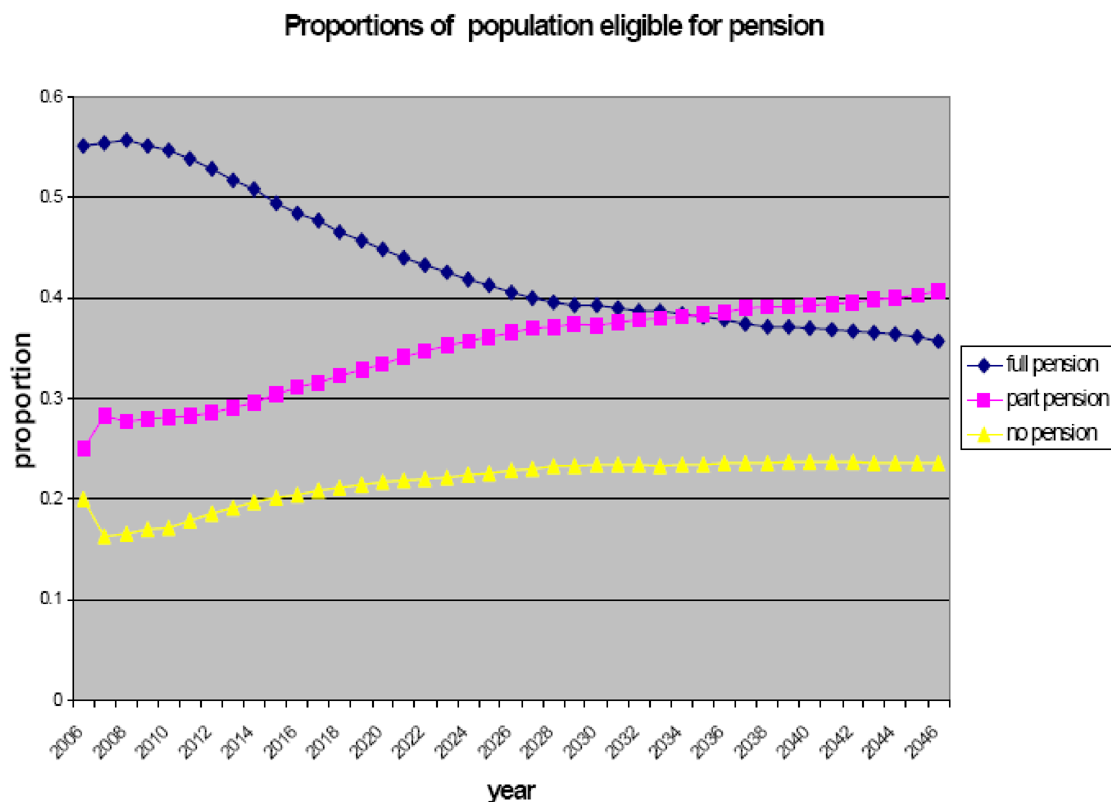
One option for this latter target is the 'modest but adequate' budget standard referred to above, which is significantly higher than the 'low cost' budget standard which we have used in this submission as a poverty measure.

Many people will not achieve this living standard under current policy settings, even when the superannuation guarantee matures in about 25 year's time. We focus on three cases: people with marginal attachment to the labour force (which refers here to those whose working life comprises less than 35-40 years' full time employment or its equivalent), baby boomers, and those with low returns on their superannuation assets.

The Intergenerational Report estimated that at that time, between 30% to 40% of people aged over 64 years will still be reliant on maximum-rate pensions as the graph below indicates.[14]

[14] Rothman, ibid.

Graph 1



Source: Rothman 2007, *The adequacy of Australian retirement income*, RIM Unit Department of the Treasury.

This implies that their income from other sources is very low. Those affected include women from low income backgrounds (who are more likely to have broken work patterns), people with disabilities, and people with low education levels and skills who are unable to secure stable employment.

These groups are particularly likely to rely on social security payments for much of their working lives, and their partners (if any) are also likely to have low incomes. This suggests that an increase in compulsory saving is not the solution to their inadequate retirement incomes. Strategies to address this problem include improving their position in the labour market (for example through better access to training, employment assistance and child care throughout working life) and direct public support for retirement incomes, for example through higher pensions.[15]

Further, because the superannuation guarantee will take decades to fully mature – to reach the point where it applies fully to around 40 years of earnings - only a minority of baby boomers will benefit fully from its introduction 20 years ago. Their typical income replacement rates will be well below those modelled above. Again, women are particularly affected. Half of all women aged 45-59 have $8 000 or less in superannuation, compared to $31 000 for men.[16] An increase in compulsory saving is not the answer to this long-term

[15] Apps 2009, *Women and retirement incomes*, National Foundation for Australian Women.
[16] National Foundation for Australian Women 2008, *Women and retirement savings*, from Kelly 2006, National Centre for Social and Economic Modelling.

transitional problem. This would unfairly reduce their disposable incomes during what remains of their working life, in order to compress around 40 years of retirement saving into a much shorter period. Policy options include encouraging those who have the capacity to do so to retire later (which both boosts their savings and reduces the assets required to finance a decent retirement income) and to supplement the superannuation guarantee with voluntarily saving, and to directly subsidise their retirement incomes.

The third group facing the prospect of low retirement incomes comprises people whose superannuation assets yield low or negative returns. The superannuation guarantee ensures that most employees receive contributions from their employer to their superannuation accounts, but the shift from defined benefits to defined contributions schemes exposes account holders to investment risk. Those most disadvantaged by this include people who retire at a time (like the present) when investment returns are negative, and less sophisticated investors whose superannuation is held in accounts attracting high fees or held in multiple accounts, and those who invest their superannuation benefits in loss making ventures. Effective regulation of the industry (especially of fee structures) and access to independent financial advice is important to keep these problems to a minimum. The development of a mature annuities market, which would be encouraged by the proposed draw-down rules for superannuation benefits (see section below dealing with 'sustainability') would also assist. However, in contrast to public social insurance overseas schemes overseas, where Governments and employers undertake more of these risks, they are an inherent feature of Australia's system of compulsory investment in private superannuation.

This discussion underscores the critical role of the first tier of our retirement income system – the age pension – as a safety net for those with inadequate income from superannuation. However, the pension is mainly designed to prevent poverty – not to guarantee a higher minimum standard of living in retirement to everyone. This leaves a significant gap in our system of retirement income support.

The World Bank recently revised its recommended three tier retirement income system to include an additional tier of public support through 'public pension plans'.[17] The purpose of this tier is to provide an additional floor for retirement incomes above and beyond safety net payments that are designed to prevent poverty. For example, social insurance schemes, which were not included in the Bank's previous three tier schema, would fit this description. An Australian equivalent could take the form of a regular Government co-contribution to all superannuation accounts. In the next part of this submission, we advocate replacement of the existing tax concessions for superannuation with a more equitable scheme along these lines. This revenue neutral option would have a similar impact on the retirement incomes of many low and middle income earners as a 2-3% increase in the superannuation guarantee. This would substantially boost the retirement incomes of most low and middle income earners but it would not address the other problems identified above – marginal labour force attachment and investment risk.

Another way to ensure that the vast majority of people achieve a modest but adequate income in retirement would be to top up the age pension. To preserve the integrity of our social security system that is targeted to prevent poverty, it would be best to do this through a separate retirement income supplement that is paid without an income test to all people over 65 years. It could initially be financed by removing a range of tax concessions for mature age people (see the discussion of 'sustainability'). To limit its cost initially, the

[17] Holzmann et al 2008, *Pension systems and reform conceptual framework*, World Bank.

payment could be absorbed into the maximum rate of pension. In effect, there would be both a maximum and minimum rate of age pension, similar in structure to Family Tax Benefit Part A (which combines the functions of a family allowance to prevent child poverty and a generalised tax credit for children).

To assist the low income groups identified above to attain a modest but adequate income in retirement in retirement, this universal retirement income supplement would eventually have to be paid on top of (in addition to) the maximum rate of pension. This would require an additional funding source, preferably through a reduction in the overall cost of superannuation tax concessions. In this way, the balance of public support for retirement incomes between a minimum level of adequate income and earnings replacement could be adjusted over time if it becomes clear that a substantial minority of Australians will not achieve adequate incomes through a combination of the income tested pension and superannuation alone.

A further option to address investment risk, especially for low income earners with savings in multiple funds, is to establish a publicly run safety net superannuation fund.

Recommendation 4:

The Government would set national targets for income replacement in retirement in consultation with relevant stakeholders, based on:

(i) attainment of a living standard through retirement broadly equivalent to that achieved through working life, taking account of the lower living costs in retirement;

(ii) a typical income profile through working life (for example the equivalent of median fulltime earnings over 30-40 years);

(iii) a limited range of family types;

(iv) a fully matured superannuation guarantee scheme.

Recommendation 5:

(i) A supplementary target would be set to ensure that the vast majority of retired Australians can attain at least a ‘modest but adequate’ income benchmark, significantly above poverty levels, from a combination of age pensions and superannuation benefits once the superannuation guarantee matures.[18]

(ii) To assist people with low superannuation benefits to reach this target, a modest retirement income supplement could be paid as a universal component of the age pension (regardless of individual and household income levels). This could be financed by removing a range of tax concessions for mature age people (as proposed in Recommendation 9 below) or by reducing the cost of superannuation tax concessions.

(iii) A further option to address investment risk, especially for low income earners with savings in multiple funds, would be to establish a publicly run safety net superannuation fund. Lost superannuation accounts could also be transferred to this fund.

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[18] When indexed to current values, these benchmarks are approximately $390pw for a single retired home-owner and $540 for a couple.

2. Equitable and efficient

Public support for retirement incomes is provided through two main sources: the age pension and tax concessions for superannuation. The pension has been relied upon to deliver fairness in the face of a highly inequitable system of taxation support for superannuation. As superannuation contributions and fund earnings accumulate, the overall retirement income system is becoming less equitable. In 2006-07, the annual cost of superannuation tax concessions exceeded that of the pension for the first time. The cost of superannuation tax concessions was $30.2 billion while that of age pensions and related payments was $26.1 billion.[19]

Efficiency concerns with the present system include:

- discouragement of workforce participation (which we discuss in the next section on sustainability),
- poor targeting of the superannuation tax concessions from the standpoint of raising long-term saving levels and reducing age pension costs,
- distortion of investment decisions in favour of a particular long term saving vehicle.

We focus here on the targeting problem.

The pension has a strongly progressive impact on retirement incomes because it is paid at flat rates regardless of previous workforce status, and is income tested. As would be expected of an occupation superannuation system, superannuation tax concessions provide more support to people with higher earnings throughout working life, and limited support to people whose workforce attachment is weak. In Australia they are particularly strongly skewed towards high income earners. The Tax Review Panel estimates that 37% of concessionally taxed contributions are paid in respect of the top 5% of workers.[20]

Another reason that the present superannuation tax concessions have a regressive impact on retirement incomes is that they provide a higher public subsidy per dollar contributed to superannuation to high income earners than to low and middle income earners. The reason for this is that the most costly tax concessions take the form of flat 15% tax rates on employer contributions and fund earnings. Of the $30 billion cost of tax concessions in 2006-07, these tax breaks accounted for $10 billion and $12 billion respectively. A tax rate of 15% is much more beneficial for those on the top marginal tax rate than those on lower earnings. For example, an employee on $120,000 a year saves 32 cents for every dollar contributed whereas there is no tax benefit for most employees on the lowest tax rate (see graph 3).

Due to a combination of the high concentration of concessionally taxed contributions among high income earners, and the higher tax discounts they enjoy for every dollar contributed, it is very likely that the top 5% of workers receive over half the $10 billion devoted each year to tax concessions for superannuation contributions.

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[19] Treasury 2009, *Tax expenditure statement*; FAHCSIA 2008, *Pension review background paper.*
[20] Taxation Review Panel 2008, *Retirement income consultation paper.*

There is no consistent policy logic to the system of tax concessions for superannuation. Before the reforms of the 1980s, superannuation was virtually untaxed and it was widely used by high income earners as a tax shelter. During the 1980s, the Government sought to reduce the cost of this tax shelter by taxing large lump sum benefits at rates of 15% or 30%, and employer contributions and fund earnings at 15%. However, in 2006 the tax on lump sums was removed for most individuals over 60 years old, without fundamentally reforming the inequitable tax treatment of contributions or fund earnings.

An efficient system of tax concessions to encourage long term saving would target low and middle income earners rather than high income earners, because high income earners are more likely to save for retirement regardless of the taxation benefits. Generous tax concessions for one form of retirement saving (superannuation) encourage high income earners to switch their investments from other savings vehicles (such as direct investment in shares and property), rather than substantially raising their overall level of saving. Another reason that an efficient system of tax concessions for retirement saving would target low and middle income earners is that they are more likely to rely on the age pension in retirement. Targeting tax concessions in this way would help reduce the future costs of the pension.[21]

Tax concessions should be capped at a level of contributions or benefits that is sufficient to fund a moderately comfortable retirement income. There is no public benefit in supporting luxurious living standards or inheritances through the tax system.

The Government co-contribution for employees is more consistent with this approach. However, it plays a modest role in overall public support for retirement savings. Further, it is confined to voluntary employee contributions and it is therefore of limited benefit to the majority of low and middle income earners who cannot afford to make voluntary contributions. To a large extent the co-contribution supports the superannuation contributions of the partners of high income earners rather than low income households. There is a strong case for subsidising compulsory contributions through the tax system as well, both on equity grounds (since most contributions for low income earners take this form) and to compensate employees for enforced saving.

Now that superannuation benefits are largely tax free, further reform to improve the equity and efficiency of the system should move the tax concessions closer to an income tax benchmark. Under this benchmark, (similar to the tax treatment of savings bank accounts) contributions would generally be made from after tax earnings and fund earnings would be taxed at marginal rates of personal income tax. The present complex and inequitable system of tax subsidies and co-contributions could then be replaced by a simpler, more transparent and fairer co-contribution or tax offset to support saving for retirement.

We raise two options to replace the present tax concessions and co-contributions for superannuation contributions and fund earnings. The first option is described in table 4 below. The tax treatment of fund earnings would remain as is. The illustrative co-contribution in this option would be broadly revenue neutral though it would shift support from high income earners to low and middle income earners. The detailed parameters of

[21] Antolin et al 2004, *Long term budgetary implications of tax favoured retirement plans*, OECD Economics Dept. Working Paper No 16.

this option are not important – what matters is to get the basic structure of the tax treatment of superannuation right.

Table 4: Existing tax treatment of contributions and ACOSS Option 1

<table>
<tr><th>Source of contribution</th><th>Current tax treatment</th><th>ACOSS Option 1</th></tr>
<tr><td>Employer</td><td>No tax on earnings collected by employer,
Flat tax of 15% on transfer to super fund</td><td rowspan="4">All contributions paid from after-tax earnings (employers deduct tax from their contributions).

A two tier co-contribution or tax offset for all contributions up to a specified annual limit, paid into the fund at end of each year.

For example, 100% for the first 0.5% AWE (approx $300), plus 30% for additional contributions up to 12% of AWE (approx $7,000)

The current limits on deductible and non deductible contributions would be replaced with a single cap (for example, $100,000 per year)</td></tr>
<tr><td>Employee</td><td>Earnings taxed at marginal rates,
Capped co-contribution for low & middle income earners</td></tr>
<tr><td>Self employed</td><td>Earnings taxed at marginal rates,
Tax deduction for contributions</td></tr>
<tr><td>Spouse</td><td>Earnings taxed at marginal rates,
Capped tax offset for contributions on behalf of spouse</td></tr>
</table>

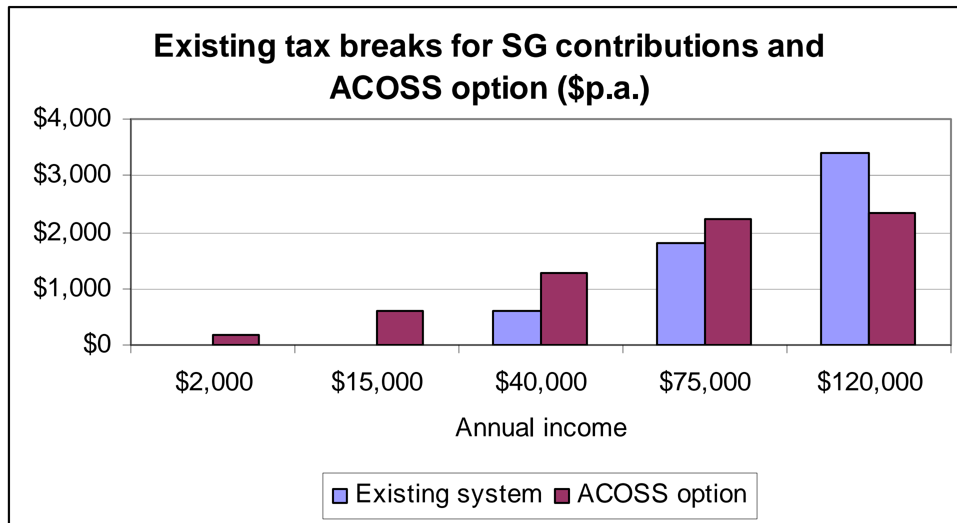
The second option is to apply income tax at marginal rates to the annual accumulations of funds in each superannuation account. Tax would be deducted annually by the fund, offset by a co-contribution or tax offset paid by the tax office along similar lines to that outlined in the first option above. This option would have a more profound impact on the overall equity of the system since the tax concessions for fund earnings cost more than those for contributions. Further, as the superannuation guarantee matures fund earnings will account for a growing proportion of overall accumulations in superannuation accounts.[22]

The following graphs compare the distributional effects of the present system and Option 1. We have not had the opportunity to model the second option, however due to the removal of the 15% flat tax on fund earnings, its impact on the distribution of public support for retirement saving would be significantly more progressive than Option 1.

[22] Income in superannuation accounts is taxed along these lines in New Zealand and Sweden.

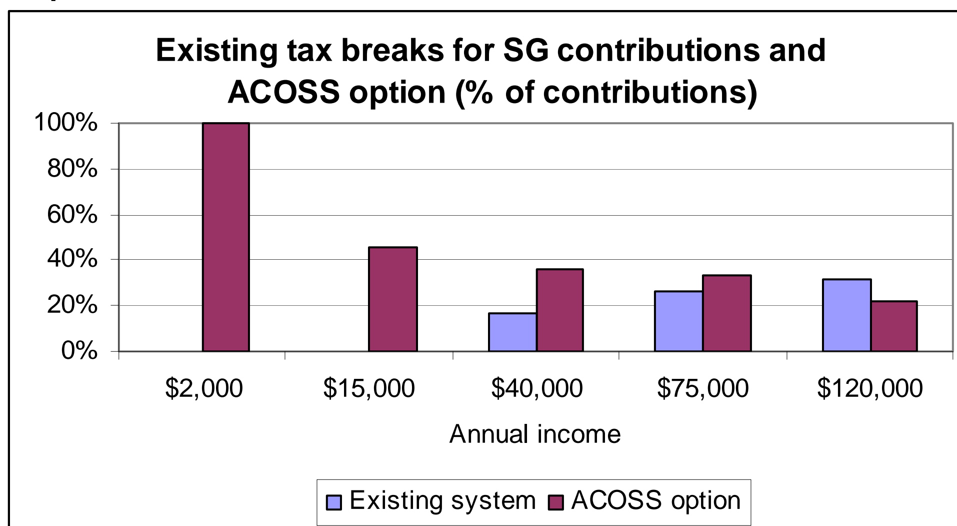
Graph 2 compares the annual dollar value of public subsidies for superannuation guarantee contributions (9% of earnings) made to employees at different wage levels in the present tax system with ACOSS Option 1. It demonstrates the effect of the flat dollar cap on the level of contributions that attract a tax concession in Option 1, which reduces existing tax subsidies for high income earners. It should be noted, however, that high income earners would still have an incentive to invest in superannuation due to the flat 15% tax on fund earnings.

Graph 2



Graph 3 shows the public subsidies available in the two systems as a proportion of superannuation guarantee contributions made at different income levels.

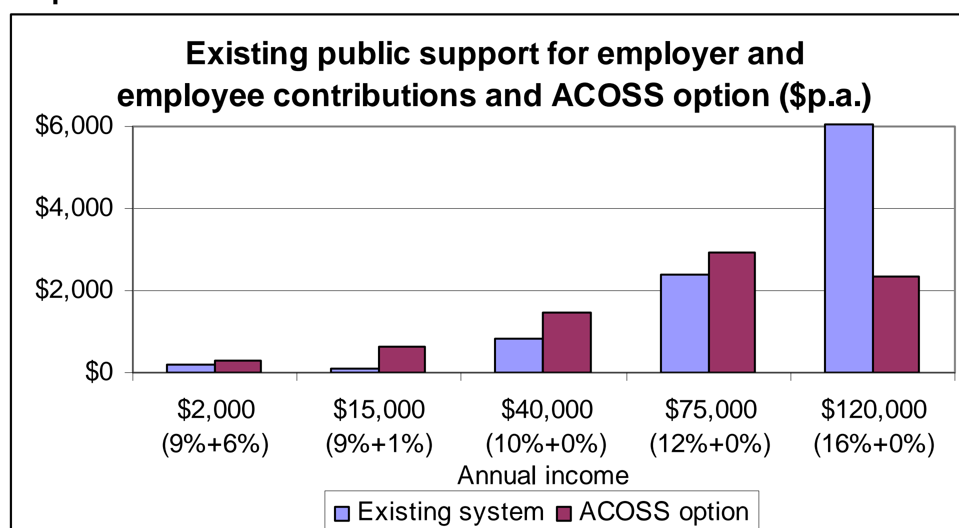
Graph 3



Graph 3 shows that the present system provides much greater support per dollar contributed by employers to high income earners than low income earners. Option 1 reverses this targeting to favour low and middle income earners. The co-contribution more than offsets the income tax that would normally be deducted from employer contributions in respect of most low and middle income earners. The effect of this change on the retirement incomes of many low and middle income earners would be equivalent to a 2-3% increase in the superannuation guarantee.

Graph 4 below compares the two systems for employees on different income levels who make typical voluntary contributions. For this purpose we assume that people on very low incomes are more likely to make employee contributions to take advantage of the existing co-contribution and that high income earners are the most likely to make substantial contributions through salary sacrifice. The illustrative levels of employee and employee contributions (respectively) are noted in brackets below each income level.[23]

Graph 4

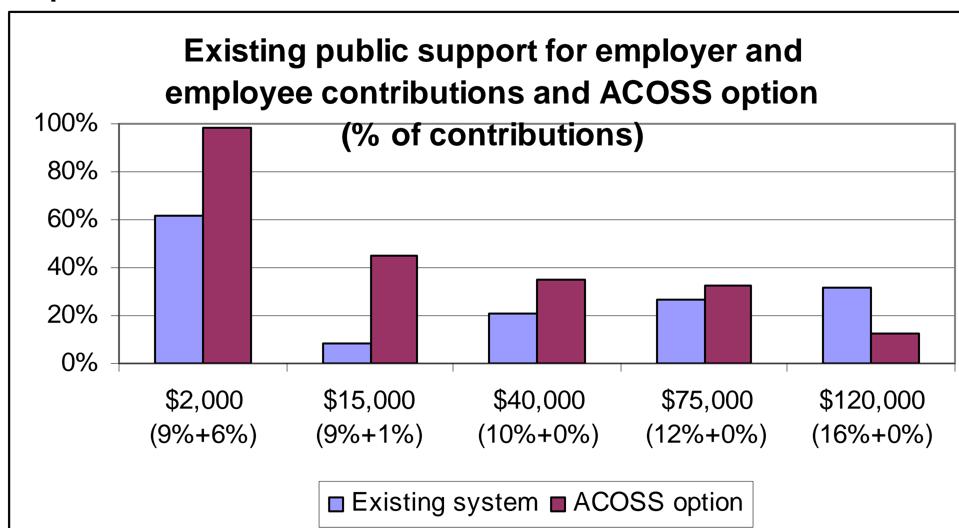


Graph 4 suggests that low and middle income earners will generally derive more benefit from Option 1 than the combination of existing tax concessions for employer contributions and the existing Government co-contribution.

[23] These are roughly based on typical contribution levels reported in Rothman 2008, *Projecting the distribution of superannuation flows and assets*, RIM Unit, the Treasury.

Graph 5 makes the same comparison based on percentages of total contributions made at each income level.

Graph 5



When graphs 4 and 5 are compared with graphs 1 and 2, the existing system appears more generous at the bottom end of the distribution (though not in comparison with Option 1). This is due to the Government co-contribution for employee contributions. However, the co-contribution is likely to have a much less progressive impact when its effects are compared across household incomes. The reason for this is that many recipients are partnered to high income earners. The regressive impact of the current system at the top end of the distribution is accentuated (as shown in Graph 4) by the high level of salary sacrifice contributions among high income earners.

In all of these examples, Option 1 provides more support for low and middle income earners than the present system. In particular, the higher rate of the proposed co-contribution for the first $300 of contributions means that low income earners would in most cases receive more support for their retirement saving than is available through the present Government co-contribution.

Option 1 is also designed to encourage voluntary saving among low and middle income earners. It would provide greater public support, per dollar contributed above superannuation guarantee levels, to voluntary saving by most low and middle income earners. The proposed co-contribution is capped at 12% of average earnings, thereby encouraging an average fulltime employee to save up to 3% of earnings voluntarily. This percentage increases at lower income levels. Support for voluntary saving by high income earners is reduced, but they are much more likely to save for their retirement with or without tax concessions.

Option 1 is intended to be illustrative. Its most important feature is not the precise level or targeting of the co-contribution, rather the change in the structure of public support for retirement saving towards one that is simpler, more transparent and fairer. The co-contribution could be targeted differently to provide more support for low income earners, to reduce its overall cost, or to boost savings incentives more for middle income earners.

Other tax concessions for retirees also contribute to inequality of retirement incomes. For example, the Senior Australians Tax Offset (SATO), which currently costs around $1 billion per year, is targeted towards a minority of retirees with incomes well in excess of the Age Pension. Tax concessions based on age, such as SATO and the Mature Age Workers Tax Offset, also raise intergenerational equity concerns.

Recommendation 6:

The taxation of superannuation contributions would be simplified and made fairer by:

(i) ensuring that all contributions are made from after-tax income by taxing employer contributions in the hands of the employer at marginal rates of personal income tax, and removing the 15% tax for employer contributions;

(ii) replacing all present tax concessions for contributions and Government co-contributions (including deductions for self employed individuals and the tax offset for spouse contributions, but not the Fringe Benefits Tax exemption for employer contributions) with a simple two tier co-contribution or tax offset for all contributions made in respect of an individual up to an annual ceiling (whether compulsory or voluntary), which would be paid annually into the fund.

Recommendation 7:

An alternative option to Recommendation 6 is to tax annual accumulations in superannuation accounts (both contributions and fund earnings) at each fund member's marginal rate of personal income tax:

(i) a co-contribution or tax offset similar to that proposed in Recommendation 6 would be paid annually into the fund.

3. Sustainable

There are currently five people of working age for every mature age person, but in 40 years this will fall to five for every two. The latest official estimates suggest that in the absence of policy changes, by 2046 Budget expenditure will rise by 4.8% and the Federal Budget will be in deficit by 3.5% of GDP due to higher health, aged care and social security spending caused in large part by population ageing. This is a modest impact by international standards, and it is noteworthy that most of the projected increase in Government expenses is in health and aged care rather than social security. However, the pressure on future budgets is probably understated because the intergenerational reports do not model the impact of population ageing on tax revenues - only the impact on public expenditure. [24]

Reform of the tax-transfer system can help ease the transition to an older population profile by raising the future level of tax collected from those mature age Australians who can afford to do so, by targeting income support better to alleviate poverty, and by encouraging workforce participation.

[24] Treasurer 2007, *Intergenerational Report.*

Targeting of income support

The age pension performs two roles. Alongside other income support payments it reduces poverty. In conjunction with superannuation and related tax concessions, it also supports retirement incomes more broadly. For example, it helps raise income replacement rates among people on lower incomes.

However, these two roles are confused in the present age pension structure. Since the income test was eased in 2000 (a reduction in the taper rate from 50% to 40%) and the assets test was eased in 2007, the pension is no longer effectively targeted towards poverty alleviation. For example, a retired couple can claim a part pension on a combined income of up to $65,000. Among mature age people this is a relatively high income (close to the income threshold for the top 20% of households over 64 years of age), especially when account is taken of the lower costs faced by those who own their homes outright and have no dependent children.

The easing of income and assets tests in recent years means that it is now more costly to increases maximum pension rates. A major increase in the pension as proposed in this submission would be more fiscally sustainable in the long term if the income test was tightened.

Careful attention should be paid to the effect of any tightening of income or assets tests on incentives to work and save. For example:

- If a low income supplement was introduced with a much tighter income test than the 'main' pension payment[25] (for example if the supplement were withdrawn dollar for dollar) this would erode work incentives among the poorest pensioners. A straightforward increase in the existing taper rate above 40% would be more equitable and probably less harmful to work incentives. There was no evidence to suggest that the 50% taper rate that applied before 2000 discouraged a substantial number of pensioners from working part time. It was widely viewed as much more supportive of part time employment than the much stricter income test on allowance payments.

- An increase in the taper rate on the assets test would probably have a more adverse effect on incentives to save than a reduction in the assets test free area, since investors would have to achieve a high rate of return to boost their disposable incomes at the margin.

If the pension were better targeted to reduce poverty, this raises the problem of how it can fulfil its wider function to support retirement incomes generally. The proposal in Recommendation 5 to introduce a universal retirement income supplement (paid as a component of the age pension) is one possible solution. Considered on its own, the proposed universal supplement might be regarded as poorly targeted. However, if it is substituted for tax concessions that mainly benefit high income earners it would improve the overall equity and efficiency of the system. It would also be a more efficient way to raise the

[25] The British pension system includes a low income supplement along these lines.

incomes of the vast majority of retirees to a modest but adequate level, as recommended above.

A separate universal supplement would leave the 'core' income tested component of the age pension free to target poverty alleviation, as proposed above.

Recommendation 8:

In conjunction with the increase in the maximum rate of pension proposed in Recommendation 2, the taper rate on the income test for the maximum rate of age pension would be raised above its present level of 40%, to up to 50%. This would be introduced progressively after the economy recovers from the present downturn.

Strengthening future tax collections from mature age people

It will be difficult for future Governments to sustain necessary improvements in health care and age pensions unless more mature age people pay income tax. Currently, only one in five individuals over 65 years old do so.[26] If this proportion does not increase, it also raises intergenerational equity concerns. Young and middle aged people will have to pay more tax or lose access to the services they need.

On the face of it, tax revenue from retirees should rise as a proportion of gross domestic product as the population ages and superannuation account balances increase, since future cohorts of retirees will have a greater capacity to pay. For example, NATSEM estimates the proportion of all household wealth held by people over 65 years will rise from 22% today to 47% by 2031. However, for the following reasons this is not assured:

- A growing proportion of the wealth of both middle aged and mature age people is held in tax preferred superannuation accounts. Retirees over 60 years old no longer pay tax on their superannuation benefits in most cases.

- Further, retirees can now reduce the income tax they pay on their non-superannuation other income (earnings and investments) by churning that income through superannuation, for example using salary sacrifice arrangements. A wage earner on $100,000 who sacrifices half their salary to superannuation, and is then paid a superannuation pension to replace their lost earnings, saves around $11,000 in tax without increasing their overall stock of retirement savings.[27] These strategies take advantage of the concessional tax treatment of superannuation compared with labour income and other investments. However, the 'churn' undermines the basic purpose of the tax concessions – to boost saving for retirement. Treasury research estimates that the amounts churned through superannuation probably exceed $10 billion each year. This has very serious implications for future public revenues.[28]

[26] ACOSS estimate using taxation statistics.
[27] Tax Reform Panel 2008, *Retirement income consultation paper*, The Treasury.
[28] Tax Review Panel 2008, op cit; Rothman 2008, op cit.

- Special tax offsets applying to retirement incomes (the Senior Australians Tax Offset and Mature Age Workers Tax Offset) raise the effective tax free thresholds of most retired people. The effective tax free threshold for a mature age couple is almost $50,000 compared with approximately $30,000 to $35,000 for a typical dual income couple of working age. [29]

The present system for collecting public revenue from mature age people has broken down. As it stands, it will not sustain the increased expenditures required by an ageing population. If the pension is improved as proposed in this submission, it is reasonable to ask those mature age people who can afford to do so to pay a greater share of income tax by removing poorly targeted tax concessions and closing off opportunities for tax avoidance.

In particular, the Senior Australians Tax Offset (SATO) lacks a clear policy rationale. It is difficult to justify a general tax offset based on age alone. Unlike the Low Income Tax Offset and the Pensioner Tax Offset, it mainly benefits higher income retirees, in particular those who are too wealthy to qualify for a pension. These tax offsets unfairly exclude people of working age.

Recommendation 9:

Age-specific tax concessions for mature age people including the Senior Australians Tax Offset and Mature Age Workers Tax Offset would be abolished, after the economy recovers from the present downturn.

Workforce participation

A key factor in the future sustainability of public support for retirement incomes and services is workforce participation among mature age people.

At present, over two thirds of men and about half of women aged 55 to 65 years are in the paid workforce. Between 65 and 69 years these participation rates fall back sharply to less than one third and less than one tenth, respectively. As the general health of future cohorts of people in these age groups improves over the next 30 years, workforce participation is likely to rise progressively.

The available evidence suggests that the three key factors affecting workforce participation decisions among people in these age cohorts are:

- Officially endorsed ‘retirement ages’ embedded in the superannuation system (55 years) and age pension (63-65 years) - these are the pivots around which retirement income decisions are likely to swing;

- Individual retirement income targets – many baby boomers are likely to defer retirement from fulltime employment once it becomes clear that their targeted income level will not be achieved if they retire early (as originally planned), and to continue working on a part time or temporary basis after leaving fulltime work;

[29] $49,700 in 2008-09 - See Treasury 2008, *Architecture of Australia’s tax and transfer system.*

- Work capacity and skills including general health, the presence of disabilities (especially among men) caring responsibilities (especially among women), and low skill levels (especially among those who are made redundant late in their careers).[30]

Broadly speaking, there are two groups of mature age people whose pathways to retirement and retirement decisions are different and distinct.

The first group, who are generally better educated and enjoyed higher incomes and better job security through working life, are able to choose their pathway to retirement, based on their income target and desired lifestyle. As the labour market tightens over the longer term, employers are likely to accommodate their preferences, for example for a gradual transition to full retirement. Their capacity to achieve their income target (the income effect) is likely to have a greater bearing on their workforce participation decisions than the marginal benefits of earning an extra dollar (the substitution effect).[31]

For the second group, who generally have lower education levels and incomes through working life, and often experience serious health problems or disabilities in mature age (or have to care for family members in this situation), retirement is less likely to be a voluntary act. The age thresholds for retirement in the superannuation and pension systems will still have an effect on their workforce participation levels at the margins, but they are much less likely to be employed and very likely to rely on the social security system for all or most of their income both before and after 'retirement'. Currently, around half of all new recipients of age pensions transition from other social security payments. This group would be strongly represented among the 40% or so of people over 64 years who are projected to rely on the maximum rate of age pension in 30 years' time[32]

Official retirement thresholds – the preservation age from superannuation and the pension age – are key levers to encourage workforce participation and later retirement. These are the gateways to alternative income sources that enable people to achieve their income targets for retirement. They also send an important signal to employers and employees about community expectations.

Ideally, both the preservation age and the pension age would vary for the two groups identified above, taking account of such factors as health, disabilities, and caring responsibilities that are largely beyond the immediate control of individuals. This would also be actuarially fairer. For example, the life expectancy of Indigenous Australians is much lower than for the population as a whole. In practice, it is difficult to fairly and consistently identify and measure most of these factors.

It makes good sense to encourage a trend towards gradual retirement that is already under way. However, the starting point for this transition to retirement in the present superannuation system – 55 years – is much too early. There is a strong case for progressively raising the preservation age to 65 years to match the pension age, and to implement this early enough to influence the retirement decisions of the baby boomer cohort. This would boost workforce participation and national income at a time when the

[30] Tax reform Panel 2008, op cit; Warren 2008, *Retirement expectations and labour force transitions*, Melbourne Institute Working Paper 24/08; Quinn 1998 *The labour market retirement and disability*, conference paper for *Income support the labour market and behaviour,* Canberra November 1998.
[31] Freebairn 1007, *Some policy issues in providing retirement incomes,* Melbourne Institute Working Paper 6/07.
[32] FAHCSIA 2008, *Pension review background paper;* Rothman 2007, op cit.

population is ageing, and prevent double dipping - where retirees draw down much of their superannuation savings so that they can maximise their age pension entitlements.

The main objection to this approach is the adverse effect it might have on the second group identified above – those who may have little choice but to retire earlier. However, the impact on this group may not be as great as it appears to be in theory, because most of this group have very limited superannuation assets.[33] Many would be better off relying on the social security system prior to age 65 and setting aside their superannuation to top up their age pension entitlements later on. This is especially the case for those on Allowance payments such as Newstart Allowance, which have stricter income and assets tests. However, if the preservation age is increased there would be still be a strong case for exempting those whose disabilities or caring responsibilities can be clearly identified as restricting their capacity for workforce participation.

Another policy option that would ease any adverse impact of a later preservation age on people who are forced to retire early is to broaden the purpose of superannuation to meet long term saving needs other than retirement, as ACOSS has previously proposed.[34] This would allow withdrawals from superannuation accounts, up to a lifetime limit, either for any long term saving objective or for a set of specified objectives (and this limitation could be removed for those over 55 years of age). If implemented in conjunction with an increase in the level of compulsory saving this should have no adverse impact on living standards in retirement.

On the other hand, a higher preservation age is likely to have a substantial impact on the workforce participation decisions of those who do have a choice to retire later. Even if the immediate effect on their disposable incomes is not substantial (given that most baby boomers currently have low superannuation balances), it would send a strong signal to employers and employees that people are generally expected to work until at least 65 years.

Whether or not this is implemented, it would be desirable to lift the age at which taxes are lifted from most superannuation benefits from 60 to 65 years so that this is consistent with the pension age and earlier retirement is not encouraged by the tax system.

The pension age itself should remain at 65 years (for women it is being progressively raised to this level). An increase in the pension age above 65 years would particularly disadvantage those people who have no choice but to retire at 65 years or earlier, since they generally have lower incomes and limited superannuation, and therefore rely more heavily on the social security system.[35] For this reason, the overall impact of such a change on workforce participation would be muted.

Further, since the age pension is much less costly than retirement income systems in most other OECD nations, Australia does not need to take such extreme action in order to keep future pension costs in check. It is likely that many of those who have a choice to work beyond 65 years will opt to transition gradually from full time employment to retirement by

[33] In 2003, 60% of those who retired before 55 years and 50% of those who retired between 55 and 59 years had an average superannuation account balance of less than $10,000. See .AMP-NATSEM 2004, *The lump sum, here today gone tomorrow.*
[34] ACOSS 2003, *Fair and flexible: reform of superannuation*, ACOSS Paper 123.
[35] AMP-NATSEM 2004, ibid.

working part time or on temporary contracts. The main objective of policy should be to progressively shift the age threshold around which these decisions are focussed from 55 to 65 years.

There is little solid evidence on the responsiveness of workforce participation decisions among mature age Australians to the effective marginal tax rates they face as a result of income tests and tax rates. Although the incomes of pensioners bunch around the pension income test free area, this may reflect to a large extent the limited work opportunities and investment assets available to the present cohort of mature age people. This may also be one of the reasons that take up of the pension bonus scheme has been low. It is not clear what impact income tests and income tax rates will have on future cohorts of mature age people who are likely to have greater earning opportunities.

Governments will need to encourage at least three groups to raise their effective workforce participation levels in order to offset the structural decline in the labour supply due to population ageing: mature age people, women with caring responsibilities, and social security recipients of working age. The second and third of these groups also face major financial disincentives to work including child care costs (for mothers) and the much steeper taper rates (up to 60%) in the income tests for unemployment allowances. Their effective marginal tax rates are likely to be much higher, on average, than those of age pensioners.

It is inequitable and counterproductive to concentrate on reducing effective marginal tax rates for one group only - mature age people. For example, the greater the gap between rates and income tests in the allowance system compared with pension payments, the greater will be the disincentive for many pensioners (such as disability support pensioners) to move from pensions to employment. This is because they then risk transfer to the lower, more stringent allowance payments.

Recommendation 10:

The preservation age for superannuation benefits would be progressively raised to equal the pension age – which will eventually be 65 years for both men and women - subject to the following conditions:[36]

(i) Individuals who have disabilities that would qualify them for the Disability Support Pension or caring responsibilities that would qualify them for Carer Payment (as assessed by Centrelink for this purpose) would be able to draw down their benefits from age 55, regardless of their income and asset levels;

(ii) If compulsory saving levels are raised beyond 9% of earnings, individuals would be able to draw down a portion of their superannuation assets before they reach preservation age, subject to a saving requirement of at least five years and a fixed lifetime ceiling on such withdrawals, either for any purpose or for a fixed set of purposes (such as education, child rearing, or housing), and then for any purpose after 55 years.[37]

[36] The target for the pension age should remain at 65 years.
[37] ACOSS has previously proposed broadening the purpose of superannuation beyond saving for retirement, within strict limits.

Recommendation 11:

The age at which superannuation benefits from taxed sources become tax free would be raised from 60 to 65 years in line with the proposed increases in the preservation age.

The tax treatment of superannuation for mature age people

There is a tension between recent policies designed to improve the flexibility of superannuation for mature age people and its original purpose, which was to facilitate saving in the pre-retirement period in order to boost incomes across the whole of the retirement period. Superannuation is becoming a general holding fund for the investment income and earnings of people beyond the age of 55 years. This raises questions about the role and validity of tax concessions for superannuation for mature age people.

As described above, pattens of retirement have changed. Instead of leaving the labour force completely after 40 years or so of full time employment (at least in case of males), people are negotiating a set of more complex and graduated transitions to retirement through part time and temporary work.

This calls into question the relevance of the traditional divide between the accumulation and draw-down phases of superannuation. Mature age people can now contribute and draw down from their superannuation accounts at the same time, a practice we described above as churning. For example, to encourage individuals aged over 55 years old to continue working and contributing to superannuation instead of withdrawing from the workforce totally, the previous Government introduced 'transition to retirement' pensions in 2004. The removal of taxes from most superannuation benefits paid to individuals age 60 or over, the easing of work tests in respect of superannuation contributions, and the easing of rules for withdrawals from tax-preferred retirement income streams also facilitate churning. Further, the easing of draw down rules for income streams and the removal of taxes on lump sum benefits mean that superannuation assets can be set aside for the next generation, instead of their intended purpose of supporting retirement incomes.

A number of restrictions still stand in the way of this practice, including the work test for contributions to superannuation for those over 64 years of age and the special rules (limitations on contributions and a requirement commence benefit payments) for those over 74 years of age. However, those with access to financial advisers are able to circumvent some of these rules, especially the very loose work test.

These issues do not generally arise prior to the preservation age because up until then individuals cannot draw down their superannuation assets. Our proposal to raise the preservation age to 65 years thus resolves these problems eventually, in regard to the 55-64 year age group is concerned. Also, the existing rules restricting contributions and requiring draw downs once an individual reaches 75 years of age resolves the problem for those beyond that age. That is clearly a draw down phase.

However, in our proposed superannuation system for mature age people the distinction between accumulation and draw down phases, along with the associated work tests, would largely be redundant for superannuation accounts held by individuals between 65 and 74

years. If superannuation is to retain its concessional tax and pension income test treatment, then a new set of rules are needed to ensure that:

- any concessionally taxed contributions represent genuine additions to superannuation savings;
- any superannuation products that attract concessional tax and income test treatment are drawn down progressively towards zero throughout retirement;
- transfers from superannuation to non dependents (as defined in superannuation legislation, that is excluding partners) are either prohibited or taxed at a standard personal income tax rate.

Otherwise, it is difficult to justify special tax and income test treatment for superannuation, as distinct from any other investment product.

Recommendation 12:

Contributions to superannuation beyond preservation age would only attract the Government co-contribution or tax offset proposed in Recommendation 6 in respect of a year in which an individual's total contributions received exceed total superannuation benefits paid.

Recommendation 13:

Contributions to and investment income from superannuation accounts beyond the preservation age would only attract concessional tax and pension income test treatment where the account complies with a simple set of rules to ensure that the assets are progressively drawn down towards zero throughout retirement:

(i) This could also be achieved in part through the deemed income rules proposed in Recommendation 19.

(ii) Alternately, these draw-down rules could be applied to all superannuation accounts by regulation.

Recommendation 14:

Subject to implementation of the previous two recommendations, age and work-based rules restricting further contributions to and withdrawals from superannuation accounts would be eased for individuals aged 65 to 74 years. The present limits on contributions and the requirement to commence paying benefits once an individual reaches 75 years of age would remain.

Recommendation 15:

Superannuation benefits transferred to a non-dependent following the death of the member (excluding former partners) would be taxed at 30%.

Financing future health and age care services

The impact of population ageing on Government expenditure will mainly be felt through higher health and aged care costs. In itself, this is desirable. As the nation becomes more prosperous and advances in medical treatment allow more mature age people to lead healthy and productive lives it makes sense to devote a higher proportion of gross domestic product to health care. The issue for debate is how this should be financed.

One option that has been advanced to finance future health care needs is a system of compulsory health insurance contributions that might be linked to the superannuation guarantee. There are two problems with this and other approaches that rely on private saving to finance health care services for mature age people:

- As noted previously, a substantial group of people of working age have limited capacity to save more for their retirement. Many either have no connection with the paid workforce, or their workforce attachment is weak. This group could be excluded from the services funded through an insurance model.

- Yet they are likely to have above average needs for health care after retirement.

Health and aged care are basic public goods. They should be financed mainly from general public revenue. This minimises the cost burden on those with the least capacity to pay while extending to them the same set of basic services that are enjoyed by their fellow citizens.

Australia currently funds part of the cost of universal basic health care services through an income tax levy, the Medicare Levy. This could be extended progressively to help meet the rising costs of health and aged care as the population ages. It could also be used to improve intergenerational equity in the funding of these services. As discussed previously, only one in five individuals over 64 years of age pays income tax, in part due to the various tax concessions for mature age people and for retirement savings. Yet it is reasonable to expect mature age people themselves to make a greater contribution to these higher costs in future, considering that in future they will hold almost half of all household wealth. This is part of the thinking behind proposals for insurance-based funding models. Any health levy to assist with these costs should therefore apply to the broadest possible income base above a low household income threshold. The current Medicare Levy ‘tax free thresholds’ exclude individuals wholly reliant on social security payments (as is appropriate), but they are also higher for those entitled to various tax offsets for seniors.

Recommendation 16:

(i) As the proportion of the Australian population aged over 64 years increases, a health and aged care levy would be progressively introduced to help finance the additional health and aged care expenses.

(ii) The levy would apply to the taxable income of all taxpayers (subject to a low-income threshold), possibly as an extension of the existing Medicare Levy.

(iii) So that mature age people make a fair contribution to meeting these rising health and aged care costs, the levy would apply to income of individuals over 64 years of age (above the low income threshold) regardless of any remaining age or retirement-specific tax offsets.

4. Simpler

The present system of pensions and income tax for mature age people is much more complex than it needs to be. Although around four out of five individuals over 64 years receives a pension, they still have to deal with two separate systems - social security and income tax - each with its own administering agency and its own method of assessing people's spending power. Since the employment arrangements and investments of the vast majority of pensioners are simple and unsophisticated, and those who pay income tax typically pay at one of the lowest two marginal rates, it should be possible to combine the two systems by applying a set of simple rules, without severely disadvantaging some taxpayers or opening up major tax avoidance opportunities for others.

If, however, such a set of simplifying rules were applied to the incomes of the top 20% or so of retirees, this could erode public revenue and contribute to inequities between generations. These retirees often have access to sophisticated financial advice and sufficient investment income to take full advantage of any tax avoidance opportunities that would arise. They have a greater capacity to achieve above average rates of return on their investment assets, so would benefit substantially from deeming arrangements. It would therefore be sensible to restrict any integration of the pension income test and income tax systems to those people entitled to pensions under the stricter income test proposed in Recommendation 8, at least in the first instance.

Integration of pension income tests and personal income tax for pensioners

A number of options have been advanced in the past to simplify the tax-transfer system for mature age people. Simply removing pensioners from the tax system, or abolishing the pension income and assets tests and relying on the existing tax system to target retirement income support, would greatly increase the cost of an ageing population. However, if the pension income test could be adjusted to collect roughly the same amount of 'revenue' that would be foregone if pensioners were removed from the tax system, then simplification along these lines would be broadly revenue neutral. This could be achieved by adding a standard income tax component (with one or more 'tax rates') to the income test taper rate. This would apply to both earnings and investment income. Since pension income tests and income tax offset each other to some extent, this would not require an effective marginal tax rate as high as the sum of the current taper rate and income tax rates combined. Another advantage of using the pension rules for this purpose is that the definitions of income in the social security system are generally simpler and more robust than those used in the income tax system.

Recommendation 17:

Subject to implementation of Recommendation 8, the tax-transfer system would be simplified for age pensioners subject to the income test, by integrating payment of income tax into the income test:

(i) This could be achieved by adding a standard income tax component (at a single rate or stepped rates, including the health and aged care levy in Recommendation 16) to the pension income test taper rate.

(ii) The income test for couples would need to be restructured so that it more closely resembles the treatment of individual income in the income tax system, for example by taking account of each individual's personal income first, and then that of their partner (as applies in the income test for Allowance payments).

(iii) Mechanisms would be needed to smooth transitions between the new income test and the income tax system for individuals over 64 years who move on or off the pension in a given year, and to prevent inequities and tax avoidance opportunities that may otherwise emerge.

Recommendation 18:

Whether or not Recommendation 17 is pursued, the definitions of income in the pension and income tax systems would be brought into closer alignment, based as far as practicable on the simpler and more robust pension definitions.

Extending the pension deeming arrangements

The system could be further simplified by extending the deeming principle that is applied to financial investments in the current pension income test. Instead of calculating each individual's actual annual incomes from their investments, the deeming arrangements apply standard annual rates of return to the annual value of these assets. A revised set of deeming arrangements could also replace income tax on the investment income of age pensioners. It is feasible to use deemed income as the tax base for investment income. Some overseas tax systems, notably in the Netherlands, already adopt a similar approach.[38]

This treatment is particularly well suited to superannuation assets, which are supposed to be devoted exclusively to income maintenance in the remaining period of retirement. If a simple deeming rule based on remaining life expectancy were applied to all superannuation assets held by age pensioners, this would encourage the steady draw down of capital over retirement in an actuarially fair fashion. This rule could replace any existing income tests and taxes applied to income derived from these assets.

Other investment assets would be assessed on the basis of deemed annual rates of return, where possible using annual valuations. Either a simple two tier deemed rate of return could be used (as at present), or different rates of return could be applied to different classes of assets.

The existing deeming rules would require some adjustment to incorporate elements of the income tax treatment of investments where appropriate and take better account of capacity to pay. For example, debt used to finance the purchase of investment assets could be taken into account by subtracting its value from that of the assets themselves.

[38] Cnossen & Bovenberg 2000, *Fundamental tax reform in the Netherlands*, CESInfo Working Paper 342.

In theory, capital gains and returns on non-financial assets such as real estate, could also be taken into account through deeming. This could be based on a combination of annual valuations and/or historical rates of return for different classes of assets. Practical difficulties with this approach include the limits on people's capacity to pay (until the assets is sold), and the wider variations between deemed rates of return on these assets and those actually achieved by investors. If these problems prove insurmountable, then these items could continue to be excluded from the deeming arrangements and a variant of the standard income test rules could apply.

If the deeming principle could be extended to most investment assets, then a further simplifying reform could be considered: to remove the assets test and to take account of the deemed income from assets through the income test alone.

Recommendation 19:

As far as practicable, standard rates of return would be deemed on investment assets held by age pensioners for income test purposes:

(i) There would be at least two deemed rates of return based on typical risk-free investment returns for different levels of asset holdings, as there is at present.

(ii) Superannuation assets would be treated separately, and deemed to generate income over the expected lifetime of the individual.

(iii) The overall net value of financial (relatively liquid) assets held in respect of an individual (after taking account of any related debt) could be calculated in order to deem an annual rate of return on those assets. Alternately, different deeming rates could apply to different classes of assets.

(iv) Non-financial assets such as real estate could either be subject to the rules outlined in (iii) above, or else the existing pension income test treatment of these investments could be retained.

(v) In cases where annual valuation of investment assets is not feasible, capital gains from these assets could either be deemed on the basis of typical annual gains for each class of asset, or taken into account on realisation (when the asset is sold). If the latter option is pursued, consideration could be given to applying a standard interest charge to offset the benefits of deferred accounting for capital gains.

Recommendation 20:

As part of these simplification reforms, the separate pension income and assets tests could be replaced by a single income test incorporating the deeming rules for investment assets in Recommendation 19:

(i) If this is implemented, then separate income test free thresholds could apply to the investment income of home owners and non-home owners respectively, as is presently the case with the pension assets test.