Chapter 2

Identifying and Quantifying Adequacy

Introduction

2.1 A major focus of the inquiry was how people support themselves in retirement. The evidence received addressed the adequacy of standards of living in retirement, and the ways in which this can be achieved. Considerable evidence was also received on the ways in which the adequacy of retirement incomes is measured and quantified.

2.2 Following a brief background section on Australia's retirement incomes system, this chapter examines the following issues:

- the objectives of the Australian retirement incomes system;
- determining an appropriate target;
- what the current arrangements will provide; and
- access to Treasury's Retirement Income Modelling (RIM) unit models.

Background

2.3 Australia enjoys a world class retirement incomes system. The World Bank has broadly endorsed Australia's general approach to the provision of retirement incomes.[1] Australia's approach is based on a three pillar system – the compulsory Superannuation Guarantee (SG), tax concessions for voluntary superannuation contributions, and a means tested age pension. Each of these pillars will be examined later in this report.

2.4 Much of the debate on the adequacy of superannuation to deliver a sustainable and dignified level of retirement income centres on the level of the inputs into the superannuation system. In other words, much of the energy is focused on the inputs rather than the outcomes or targets that the system should achieve. In the following material the questions of what the targets should be, whether those targets are the same or different for different groups, and the role of the age pension and voluntary savings will be examined.

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1 *Submission* 78, Treasury, p. 7.

Objectives of the retirement incomes system

2.5 Retirement patterns are not 'set in stone'. Commentators have identified that workers respond to the incentives they face and that changes in the relative attractiveness of work and retirement can influence individual decisions.[2]

2.6 Treasury informed the Committee that the policy objective of the retirement incomes system is to enable Australians to achieve a higher standard of living in retirement than would be possible from the publicly funded age pension alone. This is achieved through the three pillar approach of compulsory SG employer contributions, tax concessions for additional voluntary personal contributions, and the publicly funded and means tested age pension. Treasury noted that this approach has been broadly endorsed by the World Bank. Treasury also informed the Committee that the Government has not established any specific targets for retirement income levels or for aggregate levels of access to the age pension, because individual circumstances vary.[3]

2.7 The Committee was concerned that no targets or specific objectives for Australia's retirement incomes system have been identified, other than 'to enable Australians to achieve a higher standard of living in retirement than would be possible from the publicly funded age pension alone'. Accordingly, the Committee sought information on what the objectives and targets of the Australian retirement incomes system should be.

2.8 Dr David Knox of PricewaterhouseCoopers (PwC) outlined his views on the possible approaches to identifying objectives for Australia's retirement incomes system. In a detailed table he indicated that three possible objectives could be the provision of a **basic** income for all, an **adequate** income for all or a **replacement** income linked to pre-retirement income. For each of the three possible objectives Dr Knox identified the influence of the following factors or assumptions:

- retirement income goals or targets;
- incentives;
- contribution limits;
- benefit rules; and
- age pension participation.

2.9 The full table provided by Dr Knox is included **at Appendix 5.**

2.10 Dr Knox recommended the **adequate** approach as the most appropriate as, in his view, it would reduce future age pension costs, encourage long term saving and build upon the current three pillar retirement incomes structure. In his submission Dr

2 J F Quinn, 'The labor market, retirement and disability', article tabled by ACOSS during the public hearing on 9 July 2002.

3 *Submission* 78, Treasury, p.6. See also Committee Hansard, 8 October 2002, p. 672.

Knox stressed that it is important to set objectives and that one way of doing this would be to estimate the proportion of aged Australians who would receive a full, part or zero age pension.[4]

2.11 In its submission, the Institute of Actuaries of Australia (IAA) recommended that 'the Government articulate more clearly its national retirement incomes strategy, including key principles and objectives that underpin it'. The Institute considered that an appropriate objective should be to move to a position where the majority of Australians do not draw on the age pension. In the view of the Institute, this would also be consistent with one of the primary arguments for providing tax concessions for superannuation – namely the encouragement of self-provision for retirement for those able to do so.[5]

2.12 Access Economics submitted to the Committee that the link between superannuation targets and the age pension needs to be examined:

> The issue of retirement income targets was considered almost exactly 10 years ago, in 1992, by the then Labor government. The super guarantee was then expected ultimately to involve 12 per cent of earnings by 2002 and, based on a 40-year contribution life and retirement at age 65, this was expected to generate retirement income equal to 40 per cent of pre-retirement income. At that time, the government noted that about 75 per cent of people of age pension or service pension age were either full or part-rate pensioners, with about two-thirds receiving the full pension. The government stated at that time:
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> … the current levels of self-provision in retirement are far too low.
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> But it seems that the role of the super guarantee has been to reduce reliance solely on the full pension in retirement but not necessarily total reliance on the pension. That still seems to be set at around three-quarters of the retired population. Is that an adequate target? If the answer is no, what lower target is appropriate?[6]

Determinants and measures of living standards in retirement

2.13 Australia's retirement income system has many facets, including the interaction between compulsory SG contributions and the age pension. Many other factors are also involved, including the important issue of home ownership. It should be noted that the SG was designed to improve people's position in retirement, in conjunction with access to a means tested age pension or part thereof.

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4 *Submission* 110, PwC, Attachment 1.

5 *Submission* 74, IAA, p. 3.

6 *Committee Hansard*, 1 July 2002, p. 40.

2.14 Treasury made a very useful contribution to the debate on the adequacy of superannuation by outlining how it saw the drivers of income in retirement.[7] In summary, the Treasury indicated that a range of factors will influence retirement incomes:

- superannuation;
  - which is influenced by salary level and length of time in the workforce, interest rates, and fees and charges;
- other private savings;
- age pension access;
- the effect of taxation, including the Senior Australians Tax Offset;
- home ownership;
- access to Government benefits; and
- family relationships and social contact.

2.15 In view of all of these factors Treasury indicated that different replacement rates will be optimal for different individuals. A number of other submissions from industry peak bodies supported this approach.

Committee view – objectives of the Australian retirement incomes system

2.16 Recognising that a number of factors can influence the outcome, the Committee notes calls for the identification of a clearly articulated statement of high level policy objectives for Australia's retirement incomes system, together with the identification of targets for representative groups.

2.17 The Committee is concerned at the apparent absence of a clearly articulated statement of high level policy objectives for Australia's retirement incomes system. The Committee is also concerned to ensure that there is a greater focus on the outcomes of the retirement incomes system, rather than the current focus on the inputs. Current policy appears to focus on the SG and the age pension as proportions of wages and salaries rather than what people actually need in their retirement years.

2.18 The Committee notes that the Government has not set specific retirement income targets for the combination of superannuation, taxation, and age pension policy arrangements. The Committee considers that the lack of such targets causes difficulties within the community in planning for their own retirements and in maintaining realistic expectations.

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7 *Submission* 78, Treasury, pp. 4-6.

Recommendation

2.19 **The Committee recommends that the Government announce a clear statement of objectives for Australia's retirement incomes system, including target retirement incomes for representative groups.**

What is an appropriate target?

2.20 As noted above, there are many factors which contribute to people's income in retirement, with compulsory superannuation a major contributor. Much of the evidence to the inquiry sought to identify adequate retirement income targets for different cohorts of Australians.

2.21 When the SG was implemented in 1992, a replacement rate of 40 per cent of final income was the identified target at that time. This target was set to allow future communities to come to a judgement about whether the appropriate retirement saving rate should be higher.[8] In the early 1990s the Government of the day considered that the nine per cent contribution rate was not necessarily the final figure. This view is supported to some extent by the 1995 proposals by the then Labor Government to increase the contributions to 15 per cent by 2002 by providing a three per cent government co-contribution to match an employee contribution of three per cent. More detail of those proposals is included at **Appendix 6.**

2.22 Nonetheless the SG is only one of many inputs to the retirement incomes system. It is important to examine what the outcomes of the compulsory superannuation and aged pension systems are for people in their retirement years. These outcomes can be measured in terms of percentages of retirement income relative to working income (that is, replacement rates) or they can be expressed in flat dollar terms (that is, an amount in contemporary dollars, which an individual could expect in retirement).

2.23 This issue is examined below.

Replacement rates

2.24 Treasury advised the Committee that the approach its Retirement Income Modelling (RIM) unit takes is to use a replacement rate based on the ratio of average expenditure in retirement (including draw downs of capital) to expenditure in the last year of working life. Treasury also advised the Committee that the Government has not set explicit benchmark replacement rates.[9]

2.25 The IAA advised that, in its view, the most appropriate focus for assessing the adequacy of retirement incomes is the level of first year retirement income relative to the level of earnings immediately prior to retirement (and not an average over the

8 Statement by the Hon John Dawkins, MP, Treasurer of the Commonwealth of Australia, *Security in Retirement – Planning for Tomorrow Today*, 30 June 1992, p. 3.

9 *Submission* 78, Treasury, pp. 5-6, 38.

duration of retirement as preferred by Treasury). The Institute advised that this ratio is usually referred to as the replacement rate; further, that replacement rates are more robust and less subject to distortion by differences in modelling approaches than a dollar level.

2.26 The IAA also submitted that it was not possible to set 'a single optimum SG contribution rate that will provide an adequate or appropriate retirement income for the majority of retirees.'[10]

2.27 AMP Financial Services (AMP) submitted that the required replacement rate depends on an individual's circumstances, such as family size, home ownership and life style aspirations in retirement, for example:

> … if the individual does not expect to own their home at retirement, then a higher replacement rate will be necessary.[11]

2.28 The Investment and Financial Services Association (IFSA) submitted that 'the appropriate minimum replacement rate target for retirement incomes should be in the order of 75-80 per cent of late working life consumption expenditure, which approximates to 60 per cent of gross income.'[12]

2.29 The Association of Superannuation Funds of Australia (ASFA) took a different approach, indicating that its preferred approach was to use dollar outcomes as, in its view, these provide a more meaningful illustration which people can understand. The Association submitted that:

> Assessment of adequacy necessarily requires some value judgements to be made. However, both opinion polling and objective assessment of income requirements in retirement indicate that the current Superannuation Guarantee arrangements will not generate adequate retirement incomes for most individuals even when supplemented by the Age Pension.
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> Opinion polling indicates that around 70% of respondents believe they would require at least $30,000 per year in retirement, with 30% wanting at least $50,000. A variety of research studies examining expenditure by those of retirement age indicate that a budget of at least $25,000 and preferably $30,000 per year is needed for a relatively modest but comfortable lifestyle in retirement. For those on relatively high incomes prior to retirement, needs and expectations will be somewhat higher than these amounts.[13]

2.30 Subsequently, ASFA recommended that the target for a minimum retirement income for a person on around average weekly earnings be initially set at $25,000 per year in today's dollars, with this target rising to $30,000 for those retiring in 2030.

10 *Submission* 74, IAA, p. 3.

11 *Submission* 64, AMP, p. 14.

12 *Submission* 70, IFSA, p. 2.

13 *Submission* 73, ASFA, p. 4.

ASFA indicated that, in terms of replacement rates, the target might be a replacement rate of 100 per cent for a person on social security prior to reaching retirement age, 60 per cent for a person on average earnings and 50 per cent or less for a person on $60,000 or more a year. Options for reaching those targets should be based on the assumption of an average of 30 years in paid employment – earlier policy assumptions as to an unbroken work career of 40 years are no longer valid.[14]

2.31 Subsequently at the Canberra roundtable discussion on 8 October 2002, Ms Smith from ASFA expanded on this issue in the following terms:

> I would like to make some brief comments about the replacement rate and targets and then the dollar amount that was used by ASFA. I would agree that if we are using net replacement rates the target should probably be in the order of 70 to 80 per cent. If we were using gross rates, the target is probably 60 to 70 per cent.
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> …
>
> And transfers, including the pension arrangement. For lower income people the target may need to be higher than that 70 to 80 per cent. For people below or just above average weekly earnings, we may need to go for a higher target than 70 to 80 per cent just for the commonsense reason that there is a flat level below which it becomes very difficult for people to operate.[15]

2.32 In its written submission, the Australian Bankers' Association (ABA) submitted:

> ABA believes that a significant gap exists between the aspirations (and expectations) of Australians for their standard of living in retirement, and what the present system will actually deliver. Australians will achieve outcomes lower than in comparable OECD countries.[16]

2.33 The Australian Council of Social Service (ACOSS) said that it supported compulsory savings for retirement, but that there needs to be a balance between the savings for retirement and pre-retirement savings, and that the balance is wrong for low income earners. It advised the Committee that:

> Our starting point is the simple proposition that the purpose of long-term saving is to smooth expenditure across the life course. This point seems to have been overlooked in the present debate over the adequacy of future retirement incomes.
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> In this debate, the wrong questions are being asked to produce the 'right' answer: that compulsory superannuation saving should be raised by either

14 *Submission* 73, ASFA, pp. 4-5.

15 *Committee Hansard*, 8 October 2002, p. 661.

16 *Submission* 51, ABA, p. 1.

> 3% or 6% above the present 9% of earnings. This is a one-dimensional discussion about retirement income targets, without reference to the extent to which people should sacrifice current expenditure to achieve them.[17]

2.34 ACOSS further submitted that, in its view, four key questions have not been properly addressed. These questions are:

> 1. What is the minimum level of income required to avoid hardship in retirement?[18]
>
> 2. Should compulsory saving be sufficient to achieve exactly the same living standard after retirement as that attained through working life, or is it acceptable for retirement living standards to be somewhat lower?
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> 3. How should living standards be measured for the purpose of developing benchmarks for the adequacy of retirement incomes?
>
> 4. What priority should be given to saving for retirement over other long-term savings needs, such as home purchase, child rearing, and further education and training to upgrade skills?[19]

2.35 ACOSS continued:

> A good starting point for informed debate over retirement income needs is reliable data comparing future retirement *living standards* (as distinct from gross or disposable incomes) with those attained over working life.[20]

2.36 To address these questions, ACOSS advised the Committee that more research is needed:

> More research on retirement and pre-retirement living standards is needed to establish the adequacy of retirement incomes attained through the 9% Superannuation Guarantee and Age Pension. Further research is also needed to identify and quantify other long-term savings needs, especially 'life-cycle' savings needs such as child rearing, home ownership, and further education and training.[21]

2.37 Until that research is completed, ACOSS made a provisional assessment of the SG arrangements, and signalled the following broad directions for reform:

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17 *Submission* 65, ACOSS, p. 7.

18 See footnote in ACOSS submission: 'There is a common assumption that an Age Pension fixed at 25 per cent of average earnings is adequate for this purpose. This is unlikely to be so, especially for private tenants and single retirees who have run down their assets.' See *Submission* 65, ACOSS, p. 7.

19 *Submission* 65, ACOSS, p. 7.

20 *Submission* 65, ACOSS, p. 7.

21 *Submission* 65, ACOSS, p. 9.

- A compulsory retirement savings system is necessary to ensure that future generations achieve an adequate income in retirement. This should be its main objective. Easing future Age Pension and other fiscal costs should be a secondary consideration.
- The nine per cent SG saving requirement is close to the mark (though slightly too high) for middle income-earners, but it overshoots the mark in respect of low income-earners.[22]
- Although the SG fails to achieve comparable levels of income replacement for high income-earners, this is not an appropriate role for a compulsory savings regime. The SG nevertheless provides high income-earners with a decent absolute living standard in retirement, and they are in a strong position to save voluntarily to improve income replacement levels after retirement.
- It would be impractical to set different SG contribution rates for different groups in the population. The foregoing points suggest that the compulsory retirement savings requirement should be somewhat less than nine per cent of earnings.
- There is a strong case for broadening the scope of compulsory saving, and taxation support for saving, to long-term savings needs other than retirement. These long-term savings needs include home purchase, income maintenance while a parent withdraws from the paid workforce to care for a child, further education and training, and for low wage-earners the purchase of necessary assets such as cars and refrigerators (to help them avoid excessive debt levels).
- If a more broadly-based system of compulsory long-term savings were established along these lines, there would be a case for raising the SG level above nine per cent, *provided the proportion of earnings required to be set aside for retirement purposes does not exceed nine per cent* (indeed, it should be less than this, at least for low income-earners).
- On the other hand, those savings still earmarked for retirement purposes should be more strictly preserved for that purpose. The present system inappropriately encourages early retirement and allows large lump sum retirement benefits. A more rapid increase in the preservation age, and tighter restrictions on lump sum retirement benefits are likely to be resisted by many people approaching retirement age. Allowing people to withdraw a part of their compulsory savings

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22 See footnote in ACOSS submission: 'In respect of middle income-earners, this assessment is based on a presumption that a reasonable retirement income target for the *compulsory* savings system would result in a modest reduction in living standards after retirement. Those who wish to maintain *exactly the same* living standards after retirement as those enjoyed during working life (or more) could save voluntarily. Low income-earners are disadvantaged by the present superannuation system in three ways: they are forced to set aside an excessive proportion of their limited earnings for retirement, they receive little taxation support for this, and a large part of the resulting increase in their retirement income is clawed back under the Age Pension income test.' See *Submission* 65, ACOSS, p. 9.

for purposes other than retirement (within in a carefully structured long-term savings system) could ease that resistance.[23]

2.38 The Council on the Ageing (COTA) advised the Committee of the University of New South Wales Social Policy Research unit's estimate of the amount needed by different family types to achieve a 'modest but adequate' standard of living in retirement. The Council submitted that the standard is one which:

> … affords full opportunity to participate in contemporary Australian society and the basic options it offers. It is seen as lying between the standards of survival and decency and those of luxury as these are commonly understood.
>
> (and that)
>
> … the modest but adequate standard for a retired 70 year olds in 2001 is $13,260 per year for a single person and $19,500 per year for a couple. These levels, in turn, are about 30% and 15% higher respectively than the Age Pension.[24]

2.39 CPA Australia (CPA) commissioned the National Centre for Social and Economic Modelling (NATSEM) to examine the effectiveness of superannuation options in providing appropriate levels of income for people in retirement. [25] CPA Australia submitted that:

> The research clearly points to the fact that sole reliance on compulsory superannuation arrangements will not provide an adequate outcome for all Australians. Not surprisingly, an increase in the employer superannuation contributions (via a salary sacrifice arrangement), adding an employee superannuation contribution or reducing superannuation taxation, will all have a marked impact on people's living standards in retirement.[26]

2.40 PwC submitted that there is no universally agreed definition of adequacy when considering the level of retirement income, and that the influential 1994 World Bank Report *Averting the Old Age Crisis* noted that:

> The 'right' target replacement rate varies greatly, depending on the circumstances and preferences of each household and the rate of economic growth.[27]

23 *Submission* 65, ACOSS, pp. 9-10.

24 *Submission* 63, COTA, pp. 15-16.

25 Superannuation Centre of Excellence, *Superannuation the right balance?* – Report prepared by Anthony King, National Centre for Social and Economic Modelling, University of Canberra, 2001.

26 *Submission* 43, CPA Australia, p. 5.

27 Cited in *Submission* 27, PwC, p. 2.

2.41 PwC submitted that no single replacement rate or objective applies to every individual or household. Given this variability, PwC recommended that 'there must be flexibility within a long term robust system which combines a mandatory level of minimum saving and a flexible level of voluntary saving, which is encouraged by the Government through both education and taxation support.' However PwC continued:

- this initial conclusion does not prescribe the appropriate mix between the mandatory and voluntary levels of savings or the minimum level of retirement income that should arise from the mandatory pillar;
- the World Bank Report suggests that the government might require savings or contributions that would replace about 60 per cent of the worker's gross average lifetime wage with a floor at about a third of the gross economy–wide average wage;
- in the Australian context, the age pension represents an income floor of about a quarter of the average wage. In addition, 60 per cent of the lifetime wage is about 42 per cent of the gross final year wage. Hence, in setting the minimum objectives of the Australian system we should develop from the age pension level (for those with no other income) to a total retirement income of about 40 percent of the final wage for the higher incomes;
- most analysts accept that within a Government supported retirement income system, there should be a higher level of replacement income for lower income earners than for higher income earners.[28]

2.42 Dr Vince FitzGerald of the Allen Consulting Group made the following remarks on the adequacy issue at the Canberra roundtable discussion on 8 October 2002:

> There is almost a consensus of what is a First World replacement rate. Almost all of the major OECD countries seem to have systems which, although they differ in some important structural respects, produce replacement rates on the most meaningful way to talk about those—that is, net or disposable income or expenditure, or fairly similar concepts—of 70 to 80 per cent of late working career income as an income produced in at least the early stages of retirement. That essentially amounts to evidence that around the OECD world people are looking for retirement income systems that protect their standard of living; in other words, systems that avoid any large drop in standard of living in retirement. Seventy to 80 per cent of net income or disposable income replacement—that is, after taxes and pensions and the like—would typically produce something like that when you also think about the changes in the expenditure patterns of people.
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> You would imagine that over the last five or 10 years of working life a typical household unit—and I think it is best to look at household units rather than at individuals—would probably still have a mortgage, say, of $200,000 and the outgoings to service that mortgage would be something in

28 *Submission* 27, PwC, pp. 2-3.

> the order of roughly 10 per cent of income. Some other expenses you would expect to be a little bit less in retirement and you would expect people—although in many of these countries financial savings are fairly small outside pension funds or similar arrangements—to have a few other resources. That is where you get from that 70 to 80 per cent to a fairly similar standard of living—by considering these other factors: the reduced expenditure on things like a mortgage and travel to and from work or whatever and the existence of at least modest other savings to supplement the official retirement incomes of the system in those different countries.
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> …
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> Home ownership is the reason why having 70 to 80 per cent of disposable income replacement gives you a similar standard of living after retirement. In other words, if you have ceased paying the mortgage but still have the home to live in then that is one of the expenses that in some senses you have pre-funded by paying the house off before or at retirement—or in some combination. You have housing in retirement and it is extremely important for those numbers to add up to maintenance of standard of living.[29]

2.43 At the Canberra roundtable discussion on 8 October 2002, Dr David Knox, appearing in a private capacity, had the following to say on the adequacy issue:

> The 70 or 80 per cent is a good target, but we should recognise that it will not be a constant over different income levels. This has already been indicated. At lower income levels, where we will have lower home ownership on average, I would say the target should be closer to 90 per cent. At high income levels—shall we say three times the average wage—we could be looking at a 60 per cent to 65 per cent target from the system. Remember that many people at high income levels will have wealth and assets outside the super retirement income and pension system. So I think that rather than saying the target is 70 per cent to 80 per cent across the board, I would see a declining target with income rising. Seventy per cent to 80 per cent is around the middle, but 90 per cent at low incomes, perhaps declining down to 65 per cent from the system at high incomes.
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> The other point I wish to make is that we need to recognise that even within the system and within the average there are individual circumstances. Whilst 65 per cent to 90 per cent is a good band to look at, there needs to be flexibility within the system to recognise changing circumstances, different family household make-ups et cetera.[30]

2.44 Mr John Maroney, a consultant for the IAA, made the following remarks at the roundtable:

> I support the general range of 70 per cent to 80 per cent, as is included in our report, as the net replacement level. Again, I stress the need for higher

29 *Committee Hansard* , 8 October 2002, pp. 660-661.

30 *Committee Hansard* , 8 October 2002, p. 663.

> percentage replacement for lower income earners, particularly those without owner occupied housing. The variability coming from investment fluctuation, volatility and quite a range of other factors is another key issue. There will be quite a range of dispersion around the averages in this area and that is something that needs to be taken into account in monitoring adequacy at a system level and at an individual level. It is something that the complexity of the system probably works against at the moment, and I note that that is on the agenda for discussion later on. That would be the general view I have on the adequacy issue.[31]

2.45 Ms Rubinstein from the Australian Council of Trade Unions offered the following views during the Canberra roundtable discussion on 8 October 2002:

> On the question of adequacy, like everyone here, we would have no disagreement with both the dollar targets and the replacement level targets. The issue for us has always been: 'Well, what do you need to get there?' I suppose it is analogous to saying that we talk less about the living standards that workers need and more about the actual amounts of money that people are seeking. In that sense, we have supported an objective for superannuation of 15 per cent as the minimum mandatory contribution level, leaving aside from where that comes. We have supported that for some time, and most certainly since the co-contribution scheme which the previous Labor government adopted but which has not been continued as a policy by this government. That is the particular interest that we have: is 15 per cent the right amount?
>
> Certainly, at much higher levels of income, that may be less of an issue. But as far as lower income workers are concerned, there are two issues that we think need to be taken into account. One is the point that has already been made—that the needs of low income workers are going to met by a higher replacement level in retirement, simply because there is a floor to that. There is a basic level of financial support that all people will require in retirement. But the second issue is that, for low income workers, for relatively unskilled and blue-collar workers, the availability of full-time work and permanent work is declining all the time. Workers are increasingly finding themselves in casual employment, in intermittent employment and in part-time employment—sometimes voluntarily, but this is increasingly not the case. Increasingly, casual work is becoming the norm in traditional male blue-collar occupations. By its nature, casual work is going to be somewhat more intermittent than full-time work. For that reason, for those lower income workers, the need for higher provision for retirement is going to be even more critical. It is why we think that 15 per cent by and large is going to hit the target, although that is something that we would be keen to see further work done on. It is not a fixed position; if some better position was put then we would of course be more than happy to look at it.[32]

31 *Committee Hansard* , 8 October 2002, p. 664.

32 *Committee Hansard* , 8 October 2002, p. 669.

2.46 Mr Davidson from ACOSS provided a different perspective, preferring to address the broader issue of living standards rather than replacement rates:

> I will make some comments on adequacy generally and then turn briefly to the retirement age issue. To start with the basics in regard to adequacy, the purpose of saving is to defer expenditure. We should therefore aim to achieve living standards close to those we enjoyed previously—that is the purpose of saving. For that reason, we do not find it particularly helpful to set arbitrary flat dollar benchmarks or to survey people about what level of income they would like in retirement, unless we complete the picture by also asking people about their income and living standards prior to retirement and how much of their income they think they should forgo in order to achieve a certain level of income in retirement. A retirement income benchmark should be based on a proportion of living standards over the course of working life—that is, the average living standard attained over the course of retirement compared with the average living standard attained by an individual or household prior to retirement or at least during working life.
>
> If we go to living standards rather than income, we take into account a set of factors that are not often taken into account when retirement income benchmarks are discussed in Australia. These go to the different expenditure needs of retirees—that is, they have smaller households, they generally have lower housing costs and they have lower costs relating to employment. In regard to compulsory saving for retirement, we believe that the basic principle should be to set a living standards target somewhat below, but not substantially below, the average living standards enjoyed throughout the course of working life. The reason for that, of course, is that people can voluntarily top up their compulsory savings and there is no point in overshooting and securing for people, through the compulsory system, a higher living standard post retirement than that which they enjoyed previously. That would be the wrong way to go in the compulsory system. If people want to do that, they can do it voluntarily.
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> The only research we are aware of that compares living standards, as distinct from income or expenditure, pre and post retirement is that recently conducted by NATSEM. Single people saving nine per cent of earnings over 40 years and couples with children saving nine per cent of earnings over 40 years in the case of one partner and, I think, roughly 30 years full-time equivalent in the case of the other partner—to take account of child rearing and withdrawal from the labour force—were achieving around 100 per cent of previous living standards in the case of middle-income earners and around 110 to 120 per cent in the case of low-income earners. Here I am referring to singles and couples with children. It was lower in the case of couples without children, because their living standards were relatively high during the course of working life as they did not have the extra expense of children.
>
> We would not like to draw too many conclusions from a single piece of research. We think that more research that looks at actual living standards pre and post retirement is essential before we can progress this debate in any

> sensible direction. But there are some results from the study—and I am referring to the core scenario; there are a number of alternative scenarios as well—that are quite striking. One is that nine per cent looks to be about right for most in the middle, and looks to be too high for those around the bottom end. There was also previous research by RIM using an expenditure benchmark that tended to suggest that nine per cent was overshooting the mark for those at the bottom end.[33]

What will the current arrangements provide?

2.47 In order to assess the level of retirement incomes that will be available in future under current policy settings, the Committee requested the Treasury to model various personal life time experiences. The modelling assesses the combined effect of the superannuation system, the taxation system, and the age pension, on a range of real life examples.

2.48 Treasury submitted that:

> Analysis undertaken by Treasury's Retirement and Income Modelling Unit indicates that current policy will deliver substantially higher replacement rates for senior Australians, as a group, over the longer term. The Superannuation Guarantee (SG) system in conjunction with the Age Pension is projected to provide a spending replacement rate for an individual on median earnings of 72 per cent after 30 years of contributions and 77 per cent after 40 years.[34] These replacement rates are conservative in that no allowance is made for superannuation contributions above the SG or for additional private savings outside of superannuation. Replacement rates for women with interrupted careers are also calculated.[35]

2.49 In addition, the Committee sought some specific 'cameo' modelling of individual hypothetical circumstances from the Treasury. One of these scenarios was for a single male, retiring in 2032 at age 65 following 30 years of work at average earnings (100 per cent of AWOTE). Superannuation was taken as an income stream and supplemented with the age pension. The result showed that this person would receive a first year retirement income of $28,308 in 2001-02 dollars (CPI deflated). This represents a net replacement rate of 60 per cent of pre- retirement earnings, and includes 95 per cent of the age pension. **Table 2.1** shows a summary of projected retirement incomes at 75 per cent, 100 per cent and 150 per cent of AWOTE. The Treasury 'cameo' of these particular scenarios is included at **Appendix 7**.

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33 *Committee Hansard* , 8 October 2002, pp. 679-680.

34 See footnote in Treasury's submission: 'These replacement rates are based on individuals retiring in 2032. For individuals retiring under a fully mature SG system in 2042, the SG in conjunction with the Age Pension is projected to provide a spending replacement rate of 82 per cent, after 40 years of contributions.' See *Submission* 78, Treasury, p. 2.

35 *Submission* 78, Treasury, p. 2

Table 2.1: Projected retirement income for a single male, retiring in 2032 at different AWOTE

Retirement age **Career length (years)**	**70** **25**	**70** **30**	**70** **40**	**65** **25**	**65** **30**	**65** **40**
0.75 x AWOTE* (parameters in $2001-02 (CPI deflated))						
Final salary	50,711	50,711	50,711	50,711	50,711	50,711
Full age pension (average)	18,709	18,709	18,709	19,266	19,266	19,266
Private income including drawdowns (pa)	9,629	12,333	16,634	8,447	10,818	14,592
First year retirement expenditure	24,925	26,844	29,898	24,085	25,768	28,330
Average retirement expenditure $2000-01 (CPI deflated)	26,617	28,419	31,235	26,260	27,773	30,134
Average pension as percentage of maximum pension	100%	98%	96%	99%	97%	94%
Replacement ratio - first year retirement expenditure	65%	70%	78%	63%	67%	74%
1 x AWOTE* (parameters in $2001-02 (CPI deflated))						
Final salary	67,617	67,617	67,617	67,617	67,617	67,617
Full age pension (average)	18,709	18,709	18,709	19,266	19,266	19,266
Private income including drawdowns (pa)	12,953	16,596	22,452	11,362	14,558	19,694
First year retirement expenditure	27,284	29,871	33,918	26,155	28,308	31,681
Average retirement expenditure $2000-01 (CPI deflated)	28,828	31,210	35,003	28,116	30,113	33,318
Average pension as percentage of maximum pension	98%	96%	93%	97%	95%	90%
Replacement ratio - first year retirement expenditure	57%	63%	71%	55%	60%	67%
1.5 x AWOTE* (parameters in $2001-02 (CPI deflated))						
Final salary	101,422	101,422	101,422	101,422	101,422	101,422
Full age pension (average)	18,709	18,709	18,709	19,266	19,266	19,266
Private income including drawdowns (pa)	19,599	25,123	34,086	17,193	22,038	29,900
First year retirement expenditure	31,931	35,890	42,870	30,039	33,220	38,984
Average retirement expenditure $2000-01 (CPI deflated)	33,159	36,755	43,061	31,757	34,780	39,828
Average pension as percentage of maximum pension	94%	91%	86%	92%	89%	82%
Replacement ratio - first year retirement expenditure	49%	55%	66%	46%	51%	60%

* AWOTE is currently $927.60 per week (seasonally adjusted) or $48,389.80 per annum.
Scenario: single male; retirement year: 2032; benefit taken as life pension; CPI: 2.5%; wage inflation: 4%; projected fund earning rate: 7%; tax indexation: CPI; life expectancy:83 (84 if retiring at 70).
Source: *Submission* 78, Treasury, p. 40.

2.50 ASFA indicated that outcomes which are lower than Treasury projections may be more realistic. In this context Ms Smith from ASFA noted in the hearing on 10 July 2002:

> If you look … at a fully mature system, someone with average earnings of $40,000 who puts aside nine per cent for 30 years—based on our calculations of average earnings rates of about six per cent—will end up with a retirement income of $19,000. Again, that is assuming an age pension.[36]

2.51 ASFA disagreed with the Treasury findings in the strongest possible terms. In particular ASFA questioned the key underlying assumptions that Treasury used in the modelling. Mr Clare from ASFA highlighted the key areas as follows:

> We would be the first to admit that the modelling issues are not entirely straightforward—there are some technical aspects—but we will try this afternoon to do our best to explain it in the simplest terms possible. You have already identified one of the major differences between the Treasury approach and the ASFA approach in terms of the use of the deflators—the average weekly earnings adjustment that we make and the CPI adjustment that Treasury makes. Over a short period, there is not a great difference between the two but, when we are talking about periods of 30 or 40 years, the difference between the two measures—about 1.5 per cent a year, which is a common assumption between the both of us—accumulates to a very substantial amount. It is the function of the 30 to 40 years.
>
> As to what is the appropriate adjustment factor to use, Treasury claims, through the press release that was issued by Senator Coonan, which you may be aware of, that the Treasury approach is the standard one and that ASFA is using a non-standard approach. However, other very respected researchers use the same approach as we do. I have looked at a number of publications from the National Centre for Social and Economic Modelling. They use the average weekly earnings adjustment both of living expenses and of tax scales. In a way, Treasury are the odd one out in terms of the contemporary researchers, even though they have claimed otherwise in material they have released. I can give you the references for that material from NATSEM. As you would be aware, Anne Harding and her colleagues are world renowned microsimulation modellers and are subject to peer review by academic researchers around the world.
>
> As time has gone on, we have had more ventilation of what Treasury are doing, but, until very recently, it has been very much a black box in terms of some of their projections of adequacy. The more we see of those projections, the more the inconsistencies that appear to be in that model. In some ways, it goes back to that judgment about how you assess living standards in absolute terms. Do you assess them in terms of the living standards that applied when a person commenced their working career, and say that they should be very grateful that in 30 or 40 years the age pension

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36 *Committee Hansard*, 10 July 2002, p. 199.

> will generate increases in the standard of living that they will share in, or do you assess living standards relative to their last year of employment?
>
> They (Treasury) basically build in future increases in living standards that come from the age pension throughout the entire retirement period. Again, this is not a very standard approach.[37]

2.52 Ms Smith from ASFA subsequently explained further major points of difference with the Treasury assumptions:

> There was one particular flaw that we highlighted, you might remember: they had assumed that someone on average earnings by the year 2030 would be on the top marginal tax rate. Because of that, we said, 'Your post-retirement income looks good because of the fact that the pre-retirement income has gone down by that percentage.' They said they had remodelled using our figures of average weekly earnings and had got the same replacement rate. The reason they got the same replacement rate is that, in their calculations, they used a fictional annuity product. They used an annuity product which they assumed was taxed quite heavily. In the real world, annuity products are not taxed. I am saying that there has to be some care in what is being factored into the remodelling.[38]

2.53 Ms Smith and Mr Clare from ASFA responded to questioning about whether Treasury had assumed that current tax concessions for post-retirement products will not exist in 30 or 40 years as follows:

> That is one assumption. In their paper, in their modelling, the post-retirement products that they use are fictional products; they do not relate to the real world.
>
> They are products that you would be unable to purchase in the market, because they have rates of return which are much higher than the sorts of products they are talking about. They have invented these imaginary income streams which are better than what people can actually achieve in the market. That leads to some distortion.[39]

Reconciliation of the Treasury and ASFA modelling

2.54 The Committee considered that the reconciliation of the differences between the Treasury and ASFA projections was of major importance in assessing the adequacy of the current retirement income system. Accordingly the Committee commissioned the IAA to assess the differing approaches.

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37 *Committee Hansard*, 8 August 2002, p. 587.

38 *Committee Hansard*, 8 August 2002, p. 589.

39 *Committee Hansard*, 8 August 2002, p. 589.

2.55 In its report to the Committee,[40] the Institute advised that 'it is very important to realise that there is a high degree of inherent variability in the range of retirement incomes that individuals will receive, both in absolute dollars and net replacement rates'. The Committee notes this point and accepts that it follows that any hypothetical 'cameos' are simply illustrative of the possible results of the respective superannuation and social security systems – but still important in providing a framework for the debate to move forward.

2.56 The Institute found that that most significant difference in the assumptions leading to the respective results was in the use of deflators to bring future dollar values back to 2001-02 values. ASFA used the wage based average weekly ordinary time earings (AWOTE) while the Treasury used the price (inflation) based Consumer Price Index (CPI). This means that the Treasury result is inflated relative to the ASFA result by the 1.5 per cent per annum difference between projected CPI and AWOTE growth for the 30 period. On the same basis, under the Treasury approach, the 1.5 per cent difference over 30 years inflates the age pension results relative to the ASFA result and also has the effect of assuming a person on average earnings will pay 25 per cent more tax than today in 30 years time.

2.57 The Institute considered that the use of the AWOTE deflator was the most appropriate for long term projections, like the current adequacy inquiry, while the CPI was more appropriate over shorter timeframes. Accordingly the Institute considered that the Treasury and ASFA sponsored research findings were not comparable.

2.58 In terms of replacement rates, the Institute found that the net of tax retirement replacement rates from the Treasury and ASFA models were quite close. This was the most significant finding of the assessment and provided the Committee with a sound basis for proceeding with much more confidence. Specifically, the Institute found that the net retirement replacement rate for the specific cameo scenario in the Treasury model was 60 per cent and 57 per cent in the ASFA one. The full report of the IAA is included at **Appendix 4.**

Committee view – determining an appropriate target

2.59 The Committee notes that there was a high degree of consensus in the evidence presented to the Committee about the replacement rate concept as the best means of presenting future retirement incomes in terms that people can understand.

2.60 The Committee also notes that there was a high degree of consensus that the desirable net replacement rate for a person on average earnings should be of the order of 70-80 per cent of pre-retirement expenditure (approximately 60-65 per cent of gross pre-retirement income). Witnesses also agreed that this target range needed to be

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40 Institute of Actuaries of Australia, *Superannuation and Standards of living in retirement – Modelling assumptions*, Report to the Senate Select Committee on Superannuation, September 2002. See **Appendix 4.**

higher for those on less than average earnings (about 90 per cent for those on median earnings) and could be smaller for those on high incomes.

2.61 In considering what the current arrangements will provide, the Committee notes that the different approaches to modelling of projected retirement incomes used by Treasury and ASFA (based on the potential results of the current nine per cent SG and age pension provisions), produced different results in dollar terms, but very similar results in net replacement rate terms. The Committee considers that care should be taken with using dollar figures, as this may lead to misleading expectations because of the fluctuating purchasing power of the dollar over time, with wages growth and the impact of inflation.

2.62 The Committee also notes that the Treasury 'cameo', which has a replacement rate of 60 per cent for the single male, retiring at age 65 after 30 years of work on average earnings, falls short of the consensus target rate of 70-80 per cent (approximately 60-65 per cent of gross pre-retirement income).

2.63 The Committee also notes that relatively few people achieve average earnings which calls into question the validity of using average weekly earnings (AWE) as the appropriate assumption for modelling projected retirement incomes. The Committee understands that the median income is about 75 per cent of AWE, and that this level of earnings would be more appropriate for modelling purposes.

2.64 The Committee considers that the most important factors influencing the ability of a person to self fund an adequate retirement are the level of funding through quantum of contributions and the duration of those contributions. The Committee observes that no matter how well educated a person is, if there is insufficient income and saving during a person's life, an individual's expectations of a standard of living in retirement may not be achieved.

2.65 The Committee notes that the effect of more widespread casual and part-time work, broken work patterns, and early retirement or retrenchment have made the concept of a 40 year full time career obsolete. Accordingly, the Committee considers that the benchmark for an average working life, and therefore the ability of a male to accumulate superannuation contributions, is now approximately 36 years, and less for females.[41]

2.66 The Committee also notes that the Institute of Actuaries consider that the most appropriate measure of the adequacy of long term retirement incomes is the first year of retirement net replacement rate. Accordingly the Committee is persuaded that the first year of retirement net replacement is the most appropriate adequacy benchmark.

2.67 The Committee notes that the available modelling demonstrates that the net replacement rate of income in retirement for the median income groups from a 30 year career under the compulsory SG system are not sufficient to meet the consensus target

41 *Committee Hansard*, 17 July 2002, p. 336.

replacement rate of 70-80 per cent for average earners and 90 per cent for those on median earnings. By contrast, Treasury modelling produced a first year net replacement rate of about 60 per cent of final working life expenditure for those on average earnings, and 67 per cent for those on median earnings.

2.68 The Committee acknowledges that the results of any modelling in this area that seek to provide outcomes decades into the future are subject to many factors that could change the outcome. Nonetheless the Committee can only make assessments on the basis of the best available contemporary advice it receives.

2.69 Therefore the Committee concludes that, should the consensus replacement rates be accepted, the likely outcomes of the SG, taken together with the age pension, will not meet the benchmark targets of adequacy for the majority of people on or below average incomes.

Access to RIM models

2.70 Some commentators have indicated that it is very difficult to develop options to address adequacy and improve equity without access to common modelling tools. For example, IFSA submitted:

> Consideration of front-end tax impacts, and their removal, requires open access to the models used by the Commonwealth. The current debate on front-end tax removal is incomplete without a full fiscal analysis of the changes in revenue amounts and timing, and of future savings to outlays – and this analysis requires the data and models used by RIM.[42]

2.71 The Committee sought the views of the Treasury about providing wider access to RIM modelling. The Treasury responded in the following terms:

> The resources of RIM are currently more than fully occupied doing quantitative analysis of ageing, retirement income and personal income tax policies for the Government, and cannot be redirected to work in collaboration with private organisations.
>
> There would be a considerable cost in supporting the external use of RIM models because of their complexity. The use of RIMHYPO and RIMGROUP requires an understanding of superannuation, taxation and social security policy – and this combination is not common, and takes a long time to teach. RIMGROUP is so complex that it can take six months to gain proficiency in its use, and RIM is not in a position to do extensive training and support. If the models were to be made commercially available, it could take RIM a year to acquire and train staff who could support external users. To recoup costs, fees for the models would need to be high.

42 *Submission* 70, IFSA, p. 12.

> There would also be potential for conflicts of interest to arise if government officials were to work on issues identified by external organisations without the agreement of the government.[43]

Committee view – access to RIM modelling

2.72 The Committee notes that the modelling of retirement income scenarios, and options for reform, is a very complex area. The Committee has spent considerable time, and received much evidence, on the basis of different assumptions and modelling techniques. This has made consensus much more elusive than it would have been if common benchmarks and tools had been adopted by the key stakeholders. The Committee is aware that productive and worthwhile public debate can be stifled where one party can dismiss proposals and options simply because of disagreements over modelling outcomes.

2.73 The Committee notes that the public sector is not the sole repository of expertise in public policy relevant to the discussion of retirement income issues. The submissions and the evidence clearly demonstrate a very high level of understanding from industry groups.

2.74 The Committee therefore considers that, having established the objectives or goals for Australia's retirement income systems, there is a need for all key stakeholders to identify common modelling assumptions for projecting retirement incomes. At the very least, the Committee considers that RIM models should be provided to key groups so that they can model proposals for change using the same basic assumptions and modelling techniques.

Recommendation

2.75 **The Committee recommends that, having established the objectives or goals, the Treasury convene a panel of key stakeholders to identify, and where possible recommend, common modelling assumptions and techniques for projecting retirement incomes.**

43 *Submission* 142, Treasury, p. 8.