Institute of Actuaries of Australia

12 March 2009

AFTS Secretariat
The Treasury
Langton Crescen
PARKES ACT 2600

Email: AFTSretirement@treasury.gov.au

Dear Sir/Madam

Australia's Future Tax System
Draft Submission from the Institute of Actuaries of Australia
Retirement Income Consultation Paper

The attached submission (and executive summary) sets out the Institute of Actuaries of Australia's responses to the questions raised in the Retirement Income Consultation Paper (RICP), as released on 8 December 2008 (ie the retirement income segment of the review of Australia's tax-transfer system (Tax Review)).

The Institute is the sole professional body for actuaries in Australia, representing the interests of over 1,500 Fellows and 2,000 other members.

The Institute commends the government on its decision to conduct a comprehensive review of Australia's retirement income system. As you are aware, while the Institute has no vested interest in particular reforms, it does have a strong interest in seeing the adoption of sensible, worthwhile and sustainable policies that will make an enduring contribution to the community and the economy.

Our submission recommends adoption of a number of measures aimed at improving retirement income adequacy and simplifying and rationalising existing access and eligibility rules, while encouraging older Australians to support themselves financially for longer. We hope that you will find these ideas helpful.

The submission is organised around the questions specifically set out in the RICP. For completeness, however, we have set out in this letter the Institute's key observations and recommendations, as follows:

- The Institute supports the structure of the current three pillar retirement income system.
- Measures of adequacy should be based on wellbeing dollar measures, rather than on percentages of pre-retirement income replacement.
- While the 9% compulsory SG contribution will lead to adequate retirement incomes for many over the long term, its coverage should be extended to close as many gaps as possible, in particular, people with broken work patterns, self-employed persons, contractors and welfare recipients (subject to limited exclusions).

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- Until the SG system is mature, Government should mandate an increase in compulsory superannuation contributions from 9% to 12%, via 'soft compulsion' (where individuals could choose to opt out).
- Government could consider increasing the Age Pension age, over the long term, e.g. from 65 to 67, between 2025 and 2032. This would go some way to removing the community's focus on a single age (65).
- Whilst we believe that the Age Pension for couples is adequate, we believe that the single pension is inadequate.
- Government should introduce a properly structured Deferred Age Pension. This could allow for an increase in the lifetime pension of, say, between 5% and 7% for each year that a person opts to defer access to the pension. This will provide incentives for older Australians to remain in the workforce.
- The means test can be simplified by removing the income test and by taxing all income on the standard tax scales. This will significantly simplify the means test and provide incentives for older Australians to earn additional income.
- Provision should be made to allow draw downs of capital on the family home, without means testing, to mitigate longevity risk.
- The assets test should be simplified in a number of ways, with minimal impact on revenue.
- The Institute supports the current rules and practices for providing death and disability through superannuation funds. However we believe the tax should be removed on death benefits.
- We believe that the superannuation contribution tax is too high for low income earners.
- Retirement benefit calculators and Government education programs should allow for debt as well as assets. It would be useful to highlight the fact that running up large debt to carry forward into retirement is counterproductive.
- We believe the current preservation age should be retained but the Government should consider imposing limits on the amount of lump sum that can be taken out prior to retirement
- The Government should remove some of the barriers to the provision of guaranteed income products.
- We do not believe, however, that the Government should be a provider of vehicles for organisations to hedge longevity risk.

Please do not hesitate to contact the Institute (John Maroney, Chief Executive, tel. (02) 9233 3466 or Philip French, Director Public Affairs, tel (02) 9239 6111) if you require any further information.

Yours sincerely

Trevor Thompson
President

Institute of Actuaries of Australia

Response to

"Australia's future tax system - Retirement income Consultation paper"

Executive Summary

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Q1.1 In considering the future of Australia's retirement income system, which objectives are relevant in setting retirement income policy? Does the current system of the Age Pension and compulsory and voluntary savings meet these objectives? If not, how should the system be changed to meet these objectives?

The objectives of a retirement income system are:

1. Poverty alleviation ie a minimum income for all.
   - substantially achieved via pillar one, the pension.
2. To provide mechanisms to enable individuals to smooth their incomes over their whole lifetimes
   - partially achieved through the superannuation guarantee (SG) system, but further work is needed to ensure the system is expanded to cover all sections of the community and to facilitate development of better products.
3. The provision of some mechanisms by the Government to protect retirees from certain risks, such as inflation, investment, longevity, public policy, system failure
   - Achieved to only a minimal extent, with the pension providing the only real risk protection.

Australia's three pillar retirement income system provides a mix of public and private funding, to serve a range of different objectives. The Institute believes that the Australian retirement income system measures up reasonably well and provides a solid foundation for achievement of all the abovementioned goals, over time.

The pillars have, however, developed without adequate levels of integration, as a result of which there are a number of adverse incentive effects.

Suggested Changes

- **Simplify means tests and taxes**
- **Improve encouragement for labour market involvement**
- **Further encourage member contributions to superannuation with 3% "soft Compulsion"**
- **Facilitate development of a broader range of income products to address inflation/longevity**

Q2.1 As the SG system matures, it will become a greater part of an employee's retirement income. What are the implications for individuals partially or fully excluded from the mature SG system (the self-employed, individuals with broken work patterns such as carers, women and migrants), and how can the retirement income system best accommodate these groups?

The Institute agrees that the focus should be on eliminating all gaps in the SG system (including welfare recipients & self employed persons), unless a special case can be made for exclusion.

Q2.2 Noting that the adequacy of the Age Pension is being considered by the Pension Review, what is an appropriate concept of adequacy for the retirement income system? Should it be to ensure there is a minimum level of income in retirement, to replace a proportion of income earned prior to retirement, or some other alternative?

In a multi-pillared system it is appropriate that each pillar play a greater or lesser role, depending on each individual's circumstances.

Recommendation: the mandatory pillars (ie the age pension and Superannuation Guarantee) of the system should focus on absolute dollar measures, rather than on percentages of pre-retirement income replacement, that aim to relieve poverty and provide a supplement to assist Australians to achieve a "modest" to "comfortable" standard of living in retirement after age 65.

For Australians who aspire to higher standards of living in retirement or wish to retire earlier, the voluntary pillar of the system is available to help meet their own personal needs.

Q2.3 What should the role of the government be in assisting individuals to meet their retirement income expectations in relation to the support provided by the Age Pension, the level of compulsory savings and incentives to make additional savings? Should the role of government change as an individual's income increases over their working life?

Government should clarify its intentions with regard to the long term availability of the old age pension, so as to provide certainty for Australians.

Government could provide additional support for Australians who won't reach the recommended adequacy targets. Measures such as the co-contribution scheme could be expanded to provide additional support, and new measures such as targeted tax rebates that are paid into superannuation could be considered.

Government could consider providing equitable, affordable, tax incentives for third pillar voluntary savings for those who wish to save more for their retirement.

Recommendation: an increase in superannuation contributions (eg from 9% to 12%) should be achieved via 'soft compulsion'.

Government should act to improve the financial literacy of all Australians to improve their understanding of how to fund their retirement income needs, via:

(a) Proposed universal retirement income forecasts

(b) Basic understanding that superannuation is a means of investing in all asset classes (and not an asset class in itself)

(c) Clarity of objectives of the retirement income system (including superannuation)

(d) Provision of basic key messages (eg to retire comfortably without relying on the age pension at all will usually require lifetime contributions nearer to 15% than the current 9%.

Q3.1 Do the settings of the retirement income system, such as the level of SG and access to concessions, adequately consider the needs and preferences of individuals both before and after retirement?

Australia's 3 pillar system provides a high degree of flexibility and enables individuals, to the extent that they have the necessary resources, to exercise their preferences before and after retirement.

In addition to introducing 'soft compulsion' to achieve an extra 3% in contributions for many people, the Government could also improve equity across the system by reducing the contributions tax for low income earners and introducing Government co-contributions for employer contributions for low income earners.

Overall, tax support will be more evenly spread as the impact of the $50,000 annual contribution limit increases, over time.

Q3.2 Is the current level of superannuation income tax concessions appropriate and sustainable into the future? Are the current concessions properly targeted, and if not, how should they be reformed?

The tax concession regime, overall, scores quite highly against the criteria of simplicity, sustainability and operating efficiency.

The 'Better Super' reforms removed significant complexity (benefits tax), but further simplification could be achieved with minimal impact on revenue.

To improve simplicity we recommend:

- **Making death benefits tax free**
- **Abolishing age limits on contributions (or having a single maximum age)**
- **Removing other, little used, tax provisions.**

The "Better Super' reforms achieved simplicity, with some trade-off of equity. Low income earners receive little taxation support by virtue of the 15% tax on contributions and investment income, while support for higher income earners is high, due to zero tax being payable on benefits after age 60 and the natural effect of the progressive tax system.

Q4.1 At what age should an individual be able to access their superannuation and at what age should they become eligible for the Age Pension?

Discourage/limit early access to lump sum retirement savings

Allowing unlimited access to retirement savings prior to Age Pension Age is inconsistent with a means tested Age Pension. It is currently possible to retire and access unlimited superannuation benefits from preservation age (55, increasing to 60), with tax free benefits from age 60. This benefit can then be used to fund living expenses to age 65 at which time an individual may access the Age Pension (subject to the means test).

We recommend that the Government consider some restrictions on access to lump sums, especially prior to age pension age.

Possible options to achieve this include:

- Retaining preservation age of 60 but limiting annual withdrawals from preservation age to Age Pension age to the lower of a percentage of account balance (for example the 10% maximum transition to retirement limit) and a nominal lump sum limit (for example $20,000)

- Gradually increasing the tax-free age for superannuation benefits to the Age Pension age
- Including those superannuation assets withdrawn prior to Age Pension age, in excess of the 10% maximum transition to retirement limit and a nominal lump sum limit (for example $20,000), in the assessment of assets under the Age Pension test for a limited number of years.

We recommend standardising all age based rules for contributions

The Government should standardise the age based contribution rules and enable all contributions, whether employer, employee, self-employed, co-contributions and spouse contributions, to be paid at any age provided that the person is no more than 10 years older than the Age Pension age.

Age Pension age

Our previous submission (dated 30 September 2008), outlined reasons why an increase in the Age Pension age should be considered over the long term. For example, the Age Pension age could be increased from 65 to 67 between 2025 and 2032. If implemented, such a measure would go some way to removing the community's focus on a single age (65).

Q4.2 What is the role of individuals in dealing with investment and longevity risk in accumulating and drawing down their retirement income? Do financial markets provide the means to deal with these risks? If not, is there a role for government to address these shortcomings?

Australia's retirement income system is based on individual accumulations and a modest, publicly funded, means tested Age Pension. However, accumulation based superannuation puts adequacy, investment risk and longevity risk into the individual's hands. Consequently, many people will outlive their accumulations and the Age Pension alone may not be sufficient to provide them with an adequate income.

The Age Pension (Pillar 1) is, and will remain, a significant proportion of retirement income for retirees. During the recent downturn, when retirees have lost considerable savings due to poor investment markets, the pension has highlighted the diversification benefits of the current arrangements, to the extent that the Age Pension has increased to at least partially compensate for loss of assets.

With regard to longevity based products, there is no current demand for the purchase of these products by retirees. This is likely to be due to both the unattractiveness of the product and the fact that most retirees will, for the foreseeable future, receive a significant portion of their income as a (Pillar 1) pension.

Through the Age Pension, Government will remain the primary longevity insurer for the majority of retirees, hence, most retirees are protected to the extent that the Age Pension provides an acceptable standard of living.

The Institute recommends that the Government remove some of the barriers to the provision of guaranteed income products. We do not believe, however, that the Government should be a provider of vehicles for organisations to hedge longevity.

(The Institute has put forward the option of a deferred Age Pension (see section 6, below). This is a voluntary option for increasing both the average retirement age and the level of the Age Pension, which allows both the Government and individuals to better manage their longevity risks.)

Housing equity as a pillar against longevity risk.

Currently a major impediment to retirees releasing home equity, whether through downsizing or home equity release products, is the impact on the Age Pension. As owner occupied housing is exempt from the assets test, any release of housing equity is likely to result in a reduction in retirement income.

Given modest levels of projected retirement savings, high levels of home ownership in Australia, and continuing widespread reliance on the pension, ability to access home equity to sustain reasonable standards of living, and health care, is essential.

Recommendation: The Institute recommends that the safe and efficient release of home equity be encouraged.

Q5.1 In what ways does the retirement income system impose undue complexity and cost on retirees and workers? How could this complexity be reduced?

The Institute is of the view that the current pension means testing regime is both distorting and highly inefficient.

The impact of this confusing system of Age Pension reductions, personal tax rates and tax offsets is that firstly, it is extremely complicated for a person of Age Pension age who is in receipt of the Age Pension to even know the "cost" of earning additional income. Secondly, the high marginal tax rates on earned income are likely to block any desire to work beyond Age Pension age.

The Income test penalises work beyond Age Pension age, which runs counter to the Government's objectives and to the mindset it wishes to encourage.

Recommendation: The Institute recommends that earned income be removed from the means test and that simpler rules be applied to assets, with a view to both reducing complexity and improving labour market participation amongst older workers.

Q6.1 The Age Pension serves two roles, as a safety-net for individuals who are unable to sufficiently save for their retirement and as an income supplement for many individuals who do save. What should be the role for the Age Pension and means testing in a future retirement income system and what impact does this have on its sustainability into the future?

The Age Pension serves both roles, that of a safety net and as one of the three primary pillars of retirement income. With 80% of those aged 65 and over (only reducing to 75% in 2047) relying on all or part of the Age Pension, the Age Pension will remain a primary pillar of retirement incomes for many decades.

The Age Pension is affordable at current levels, (being less than 5% GDP), however, affordability will be in question if the Age Pension is increased, for example, to address any shortfall for singles compared to couples and any overall shortfall relative to modest standards of living, especially if longevity also continues to increase.

The removal of earned income from means testing is akin to paying universal pensions for specific levels of assets. This retains the key advantage of means testing (targeting scarce resources) whilst minimising the key disadvantage (e.g. high administration costs).

Means testing based on assets only, is considerably easier to administer and less intrusive.

Q6.2 In what ways does retirement income policy affect workforce participation decisions and what, if any, changes might reduce disincentives to work? Does the sustainability and cost of the retirement income system affect the workforce decisions of younger generations of workers?

With the ageing of the population, increasing workforce participation among older workers will become increasingly important if economic growth is to be maintained.

A range of initiatives which improve population, participation and productivity, will be required to meet the challenges of our ageing population.

Currently, people are retiring well before the Age Pension age. The average age at retirement for people aged 45 years or more and who retired in the last five years was 61.5 years for males and 58.3 years for females, which is substantially lower than the Age Pension age of 65 for males and 63.5 for females. This is also reflected in a significant reduction in workforce participation rates for Australians over age 55. For example, male workforce participation rates reduce from 90% for 25-54 year olds to 66% for 55-64 year olds.

Society, as a whole, will benefit from measures designed to encourage older Australians to support themselves financially for longer and to a greater extent than is currently the case, through a combination of work and savings and/or family support.

Deferred Age Pension

Recommendation: The Institute recommends that the Government consider introducing a Deferred Age Pension. In effect, for each year that the pension is deferred it would be increased by, say, 5% to 7%. This would provide a financial incentive to carry on working.

The Government may also consider increasing the Age Pension age from, say, 65 to 67 between 2025 and 2032. This would go some way to removing the community's focus on a single age (65). These initiatives, together with the removal of the earned income test and simplification of the complicated system of existing "mature age" tax offsets into one simpler "mature age" tax offset would reduce the disincentives to work.

Q6.3 What impact could financial intermediation have on the effectiveness of retirement income policy?

One of the intended economic benefits of compulsory superannuation was to increase national savings. However, the rate of household savings has actually decreased since the introduction of widespread participation in superannuation.

While the rate of superannuation savings climbed steadily over the past 15 years, households are saving less, primarily as a result of increased borrowings. Increased savings through superannuation have been almost exactly offset by increased levels of household debt.

Financial deregulation and the resulting competition among lenders have increased the availability of consumer debt. This financial intermediation has increased consumers' ability to effectively access their superannuation before retirement (by borrowing now and paying off the debt at retirement).

It would not, however, be desirable, or realistic, to curb financial intermediation or lending to senior Australians in order to achieve superannuation policy goals.

Recommendation: The Institute recommends two policy changes in superannuation which may change individual behaviour to encourage lower levels of debt at retirement:

- **Upper limits on lump sum withdrawals.**
- **Universal benefit projections for superannuation - provide each member of a superannuation fund with an annual projection of their likely benefits at retirement.**

Institute of Actuaries of Australia

Response to

"Australia's future tax system - Retirement income Consultation paper"

12 March 2009

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1 The retirement income system

Q1.1 In considering the future of Australia's retirement income system, which objectives are relevant in setting retirement income policy? Does the current system of the Age Pension and compulsory and voluntary savings meet these objectives? If not, how should the system be changed to meet these objectives?

The Institute believes that the objectives cited by the World Bank (1994 – Averting the Old Age Crisis – Policies to Protect the Old and Promote Growth) are appropriate objectives for Australia's retirement income system ie:

Old age security programs should help the old by:

- Facilitating people's efforts to shift some of their income from their active working years to old age
- Redistributing additional income to the old who are lifetime poor
- Providing insurance against the many risks to which the old are specially vulnerable

Such programs should also facilitate the broader economy.

The Institute also subscribes to the views of Holzmann and Hinz, in the World Bank report "Old Age Income Support in the 21st Century":

- There is continued relevance of the main objectives of pension systems – poverty alleviation and consumption smoothing - and of the broader social goal of social protection
- All pension systems should, in principle, have elements that provide basic income security and poverty alleviation across the full breadth of the income distribution.

The Institute believes, therefore, that the objectives of a retirement income system are

1. Poverty alleviation ie a minimum income for all
2. To provide mechanisms to enable individuals to smooth their incomes over their whole lifetimes
3. The provision of some mechanisms by the Government to protect retirees from certain risks, such as inflation, investment, longevity, public policy, system failure.

- In relation to the various long term risks and objectives, Holzmann and Hinz state that "experience has demonstrated that the multi pillar design is better able to deal with the multiple objectives of pension systems … and to address more effectively the kinds of economic, political and demographic risks facing any pension system. The proposed multi pillar design is much more flexible"
- They also say, however, that "most pension systems in the world do not deliver on their social objectives, they create significant distortions in the operation of market economies, and they are not financially sustainable when faced with an aging population."

The World Bank multi pillar system envisages 5 pillars, comprising;

- A non – contributory government funded basic pension (ie as in Australia, since 1909)
- A mandatory contributory public pension with modest benefits (ie a social insurance style pension, such as operates in the UK)
- A mandatory occupational or personal pension (ie as per 9% superannuation guarantee)
- A voluntary occupational or personal pension with flexibility (ie as per Australia's tax advantaged voluntary contribution system)
- Non-financial assets, such as informal support networks, the family home and various social programs.

Australia's retirement income system boasts 4 of the above 5 pillars, with a mix of public and private funding, serving a range of different objectives. As noted in the consultation paper, the pillars have developed independently. Integration of the pillars is difficult and can result in adverse incentive effects.

What are the characteristics of an ideal system?

Overall design

- It should be adequate – protecting the poor and providing mechanisms to save
- It should be sustainable – financially sound over the long term
- It should be robust – able to withstand shocks to the system

Interaction with individuals/community

- It should be transparent – simple and approachable, so as to be easily engaged with
- It should be accepted by society and not, therefore, subject to constant change
- It should be equitable and accepted by most people as being fair/not unfair
- It should be affordable by individuals, attractive and flexible

Some secondary objectives or goals

- Minimise hidden costs
  - Excessive fiscal burden
  - Misallocation of capital
  - High administration costs
- Minimise negative impact on labour market
  - Particularly relevant within an ageing population
- Reward risk taking and development of capital markets
- Recognise that we are not all the same
  - Ensure some flexibility
- Enable reasonable levels of retirement income to be provided

Objectives - how do we measure up?

The Institute believes that the Australian retirement income system measures up reasonably well and provides a solid foundation for achievement of all the abovementioned goals, over time.

- Poverty alleviation – substantially achieved via Pillar 1, the pension

- Mechanisms to smooth income – movement towards fulfilling this objective is partially achieved through the superannuation guarantee (SG) system, but further work is needed to ensure the system is more broadly inclusive (eg extending coverage to all self employed persons and casual employees with multiple jobs). Australia also lacks products which facilitate individuals in their efforts to smooth their incomes over the longer term

- Risk protection – again, our system leaves much to be desired. While the pension does act as risk insurance for some, the superannuation system does not offer anything in the way of risk protection

Characteristics – how do we measure up?

- Overall, the system rates quite highly on adequacy, with the age pension, SG and voluntary superannuation – there are gaps, however

- The system is sustainable in its present form, with long term costs to the taxpayer limited and well understood by governments

- The system has a degree of robustness, able to provide limited support when shocks occur

- The system falls down somewhat on the criteria of transparency – the interaction of various means tests and taxation thresholds makes it very complex and difficult to negotiate

- Levels of acceptance are high, with broad community support for both SG and the pension

- The system is reasonably equitable, with some inequities in the tax support for SG and voluntary contributions

- The system is flexible. It is more attractive to the relatively small number of higher income earners than it is to the bulk of wage and salary earners, who are already subject to relatively low marginal tax rates.

Secondary objectives – how do we measure up?

- Our system has reasonable administration costs

- Importantly, however, it discourages participation at older ages

- In the risk reward trade-off, while capital markets have developed, members are exposed to a range of risks, which they must manage themselves

- The system is flexible, recognising that we are not all the same

- Some members are able to achieve reasonable levels of retirement income, but contribution caps limit income for some and low contribution levels inhibit this goal for many more.

Suggested changes to make the system more efficient

- Simplify the means tests and taxes
  - Remove double effect
  - Improve encouragement for labour market involvement
- Encourage member contributions with 3% soft compulsion
  - Involvement and flexibility
- Introduce broader range of Government securities
  - Enable a broader range of income products to address inflation and longevity risks

2 A broad and adequate retirement income system

Q2.1 As the SG system matures, it will become a greater part of an employee's retirement income. What are the implications for individuals partially or fully excluded from the mature SG system (the self-employed, individuals with broken work patterns such as carers, women and migrants), and how can the retirement income system best accommodate these groups?

The Institute agrees that the focus should be on eliminating all gaps in the SG system (including welfare recipients & self employed persons), unless a special case can be made for exclusion.

While appropriate mechanisms for ensuring adequate SG coverage for groups such as welfare recipients and self employed persons with multiple jobs are not immediately obvious, it is important that these groups are included before SG can be accurately described as universal.

Q2.2 Noting that the adequacy of the Age Pension is being considered by the Pension Review, what is an appropriate concept of adequacy for the retirement income system? Should it be to ensure there is a minimum level of income in retirement, to replace a proportion of income earned prior to retirement, or some other alternative?

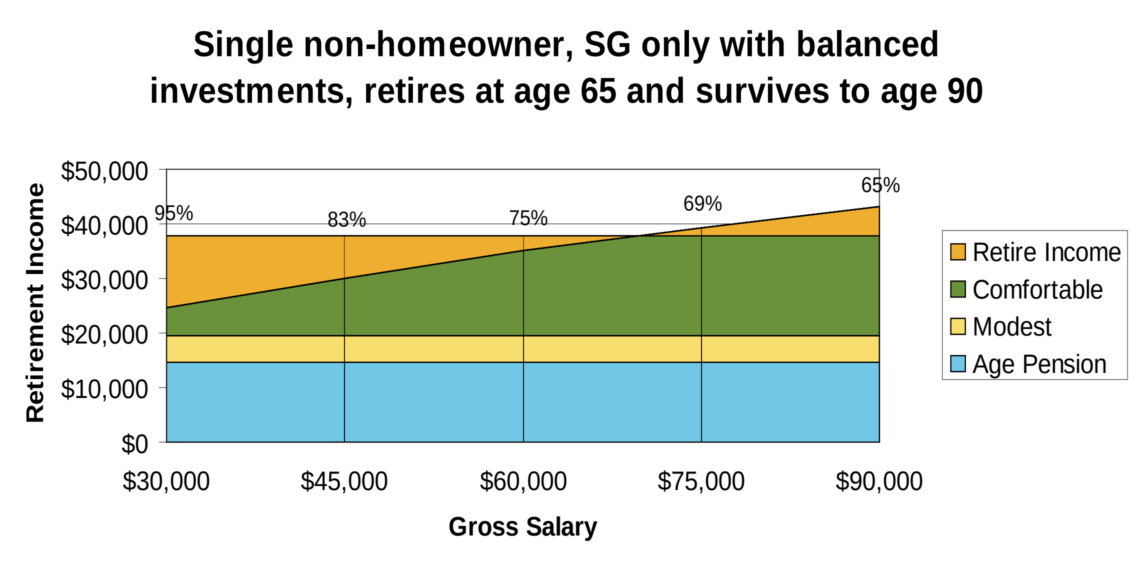
First of all, we need to acknowledge that the retirement income system is intended to be a multi-pillared system, with each pillar playing a greater or lesser role depending on the individual's circumstances. While it makes sense for the individual to focus on a replacement ratio (for example, expressed as a percentage of after tax income), the Institute believes that the mandatory pillars of the system should focus on absolute dollar measures that aim to relieve poverty and provide a supplement to assist Australians to achieve a "modest" to "comfortable" standard of living in retirement after age 65.

For Australians who aspire to higher standards of living in retirement or who wish to retire earlier, the voluntary pillar of the system is available to help meet their own personal needs. As pointed out in Chapter 1 of the Consultation paper:

> *"The Age Pension will continue to be an important source of income for median income earners (around 75 per cent of average weekly ordinary time earnings (AWOTE)) and average income earners."*

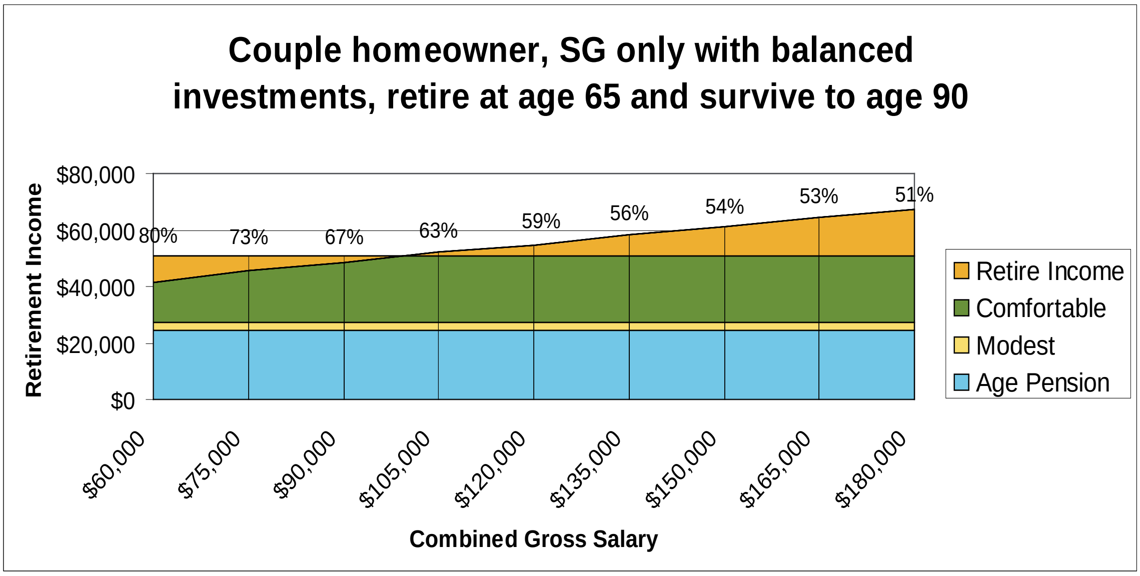
Given that average weekly ordinary time earnings (AWOTE) is currently around $60,000 per annum, 75% of AWOTE is, therefore, currently around $45,000 per annum. Using ASIC's fido retirement planner, we have assessed the retirement incomes across various income levels based on a mature SG system. The core assumptions include:

- The person joins the workforce at age 25;
- The person has a career break for 5 years at age 45;
- The spouse or partner (where applicable) has a 10 year career break at age 30;
- The superannuation investments earn 8%pa;
- The person retires at age 65 and lives until age 90.



For a single person, the horizontal benchmarks in the above chart show the current level of the Age Pension (around $15,000 pa), the Westpac-ASFA Retirement Standard's "modest" level (around $20,000 pa) and "comfortable" level (around $38,000 pa). It is worth noting that the single Age Pension is about 76% of the "modest" level. If the Age Pension was increased from about 25% of AWOTE to 30%, it would then be about 90% of the "modest" level.

For a low income earner ($30,000 pa), the combination of the Age Pension and a mature SG system provides a replacement ratio of about 95% of pre-retirement post tax income and an above modest standard of living. For a median income earner ($45,000 pa), the replacement ratio falls to about 83% but the person's actual standard of living is higher. For an average income earner ($60,000 pa), the replacement ratio falls further to about 75% however the person's standard of living almost reaches the "comfortable" level. At an income level of $90,000 pa (about 150% of AWOTE), the replacement ratio is still a reasonable 65% and the expected standard of living is well above the "comfortable" level.



For a couple, the horizontal benchmarks in the above chart show the current level of the Age Pension (around $24,000 pa), the Westpac-ASFA Retirement Standard's "modest" level (around $27,000 pa) and "comfortable" level (around $51,000 pa). It is worth noting that a couple's Age Pension is about 90% of the "modest" level.

For a low income couple (where both partners earn $30,000 pa), the Age Pension provides a much higher base level of income and a replacement ratio of about 80%. For a median couple (where both partners earn $45,000 pa), the replacement ratio is a reasonable 67% and almost at the "comfortable" level. For an average couple (where both partners earn %60,000 pa), the replacement ratio falls to about 59% however the expected standard of living is well above the "comfortable" level. At higher income levels, the replacement ratio continues to fall (to about 51% for a couple where both partners earn $90,000 pa), but of course the actual standard of living continues to rise.

Ultimately, adequacy is a very individual outcome that depends on numerous factors. Expenditure patterns in retirement also vary at different ages, such as the active, passive and frail stages. Health and aged care costs, as well as home ownership, are factors that also need to be considered.

Q2.3 What should the role of the government be in assisting individuals to meet their retirement income expectations in relation to the support provided by the Age Pension, the level of compulsory savings and incentives to make additional savings? Should the role of government change as an individual's income increases over their working life?

As shown in section 2.2, the current Age Pension and SG contributions at 9% of earnings appears to provide adequate retirement income levels for the vast majority of Australians, once the SG system matures (ie. for people who joined the workforce since 1 July 2002).

However, there still seems to be some apprehension about whether the Age Pension at its current level will still be affordable in 30 to 40 years time and, therefore, whether it will be changed to become less available. It would be helpful if the government clearly and regularly clarified its intent in this regard to provide greater certainty for Australians. This could form part of an overall campaign to improve the financial literacy of all Australians to improve their understanding of how to fund their retirement income needs.

The Government needs to provide additional support for Australians who won't reach the adequacy targets set out in section 2.2, especially for low to average income earners. Measures such as the government co-contribution scheme could be expanded to provide additional support, and new measures such as targeted tax rebates that are paid into superannuation could be considered.

As the compulsory component, 9% SG appears adequate to get most younger people into this range (especially if the option of a deferred age pension is made available)

The Institute is of the view that any increase over the 9% SG should be achieved through the use of 'soft compulsion' (of say an extra 3%) that would allow people to drop back to 9% if they preferred, or needed to do so.

While an aged based approach could be considered, it may add unwanted complexity.

In addition to the Government's role of setting the SG level and providing suitable tax incentives to promote more income smoothing, there is a strong need for community education about retirement saving, via:

(a) Proposed universal retirement income forecasts

(b) Basic understanding that superannuation is a means of investing in all asset classes (and not an asses class in itself)

(c) Clarity of objectives of the retirement income system (including superannuation)

(d) Provision of basic key messages (eg to reach retirement comfortably without relying on the age pension at all can require lifetime contributions exceeding 15% of income, depending on a range of factors, including the number of years of contributions)

3 An acceptable retirement income system

Q3.1 Do the settings of the retirement income system, such as the level of SG and access to concessions, adequately consider the needs and preferences of individuals both before and after retirement?

Possible improvements include:

(a) Tax support will be more evenly spread, once the impact of the $50,000 annual contribution limit spreads through the system over time

(b) Government co-contributions could be applied to employer contributions

(c) The 15% tax on contributions could be reduced for low income earners, to the extent necessary to ensure that they also have an incentive to contribute ie the contribution tax should at all times be lower than the marginal tax rate applying for low income earners.

Q3.2 Is the current level of superannuation income tax concessions appropriate and sustainable into the future? Are the current concessions properly targeted, and if not, how should they be reformed?

Appropriate? Why have tax concessions?

To consider whether the tax concessions are appropriate it is first of all necessary to consider why tax concessions are provided. As noted in the Retirement Income Consultation Paper, the commonly stated rationale is as follows:

- Tax concessions provide additional government support to assist in achieving adequate retirement incomes
- The tax expenditure now may reduce future Age Pension outlays
- They encourage voluntary additional contributions
- They provide compensation for the inability to access funds until retirement

The validity of these aims should be viewed through the prism of design principles suggested below.

Design Principles

Section 1.2 of the consultation paper discussed some design principles for the tax transfer system.

Design Principles

Simplicity

Sustainability

Efficient – operating costs

Efficient- economic

Equity

We believe that the Australian tax concession regime, overall, scores quite highly against the first 3 criteria (simplicity, sustainability, operating efficiency). As will be detailed below, the areas which are most in need of reform are equity and economic efficiency.

Simplicity

The Better Super reforms (announced in the 2006 Budget) removed significant complexity (benefits tax). As the Institute noted in its analysis "Tax-free superannuation benefits: a future revenue problem?", the system of taxing benefits raised little tax revenue and added significant complexity".

While the reforms did simplify the system, areas of complexity remain. Some suggestions regarding areas which can be remedied with little impact to revenue are as follows:

Area of complexity	Detail	Recommendation
Death Benefits	Taxes on death benefits raise very little revenue (less than $0.2bn) Some benefits are taxed at either 0%, 15% or 30% depending on whether the dependent status of the beneficiary, age of the beneficiary. The amount of tax can depend also on the deceased member's periods of service. Multiple anomalies in the system exist and tax can be minimised with financial advice. (eg for death benefits paid in retirement to adult children)	Make death benefits tax free.
Benefits paid before age 60	Different tax rates still apply to different due to legacy components Little revenue is raised from these taxes (less than $0.2bn). Most lump sum benefits are effectively tax free anyway due to the existence of the tax free threshold of $145,000 (most retirement benefits are less than $145,000)	Make all benefits tax free by aligning the Preservation Age and Tax Free Age
Different Ages for contribution limits	Different rules apply for contributions after age 65 for SG, personal and salary sacrifice contributions	Either abolish the Age Limits on contributions or have a single maximum age (eg 75)
Little used tax provisions	There are several little used provisions which cause administrative complexity eg Contribution Splitting, Spouse Rebate, Children super	Remove these provisions

Sustainability

There are two aspects to sustainability:

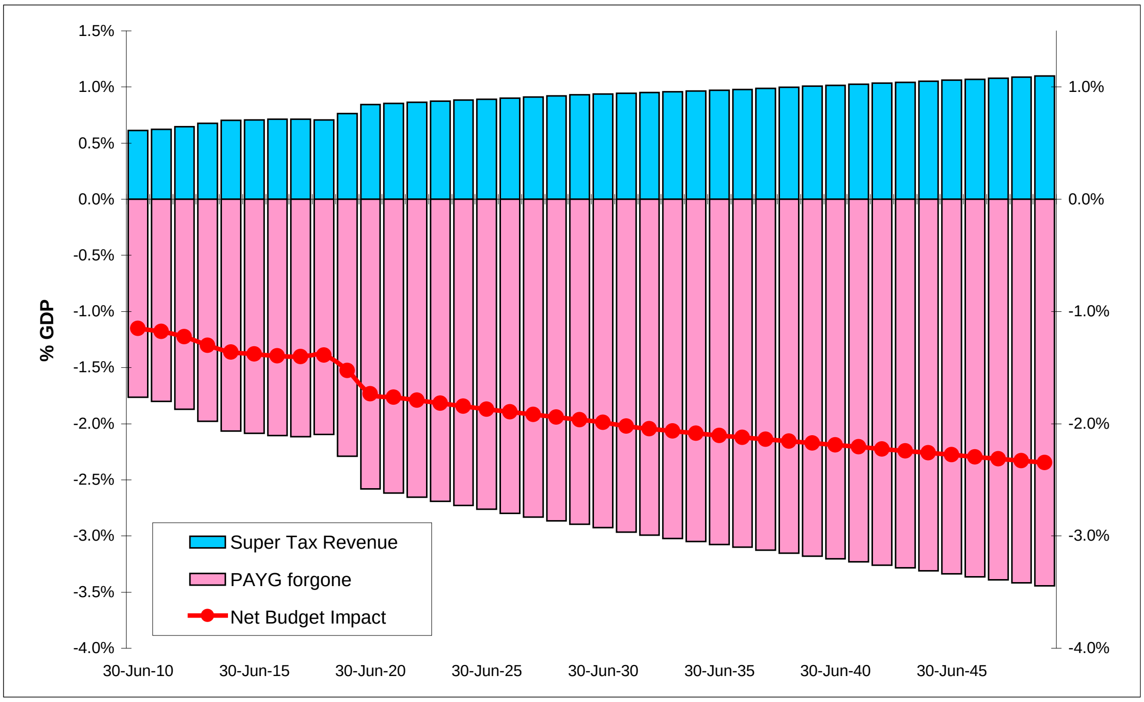
1. Is the growth in projected tax revenue / tax expenditure sustainable?

2. Does the future reduction in Age Pension outlays justify the tax expenditure?

1. *Projected Tax Revenue / Expenditure*

Recently some estimates of the projected impact of the current taxation arrangements for superannuation were presented at the Institute's Super Policy Forum by one of it's members (Darren Wickham).

Tax Revenue / Expenditure as a proportion of GDP



Source: Darren Wickham Presentation to Super Policy Forum 19 February 2009

If the pattern of revenue and expenditure experienced is similar to the results above, then a conclusion that can be drawn is that the net fiscal impact as a proportion of GDP is relatively stable over the next 30 years. The current tax arrangements may, therefore, be considered sustainable on this basis.

2. Reduction in Age Pension Outlays

The interaction between Superannuation and Age Pension is an important aspect of the assessment of sustainability. In particular, does the future reduction in Age Pension outlays justify the tax expenditure on superannuation?

Superannuation savings increase the level of assets for individuals at retirement and therefore reduce pension outlays via the operation of the means tests.

It has been estimated that the operation of the means tests (on non super as well as super assets) currently save around $11bn[1] per annum in Age Pension outlays.

While the reduction in pension outlays achieved is, therefore, only modest these measures have a number of objectives. The system is also aimed at increasing national savings and developing a savings culture, as well as generating higher retirement incomes and, therefore, higher standards of living.

[1] Wickham / Dunsford Cost of Universal Age Pension

While we have not performed long term modelling of these relative costs and benefits, it is likely that the tax expenditures will significantly outweigh the savings in the Age Pension outlays relating to superannuation. This is primarily because the structure of the tax expenditure in superannuation results in most of it being directed to high income earners who are never likely to draw the Age Pension (see section below on Equity).

Efficiency - Economic

Do superannuation taxes distort economic choices in an undesirable way? Superannuation tax concessions provide an explicit incentive for individuals for behavioural change, ie to prefer superannuation over other investment structures.

This is a deliberate distortion in decision making designed to achieve broader economic goals (reduced Age Pension outlays, increased national savings) and social goals.

Do the deliberate incentives have the desired economic impact?

Behavioural Change

Since SG Contributions are compulsory, tax expenditures that relate to them cannot really achieve behavioural change, (except perhaps if there was evidence that employers deliberately moved to hiring contractors in greater numbers, and we don't believe there is). Approximately $18bn out of the $24bn[2] in tax expenditures relate to compulsory contributions.

It is arguable that a substantial part of the tax expenditure relating to superannuation does not affect behaviour, and therefore there is a question mark about the economic efficiency of providing the expenditure.

There is evidence that higher income earners make higher level of voluntary contributions to superannuation. This is likely to be due to concessional tax arrangements.

Better targeting of tax expenditure away from compulsory contributions and towards voluntary contributions may generate more substantial behavioural change and have a proportionally greater impact on encouraging voluntary savings. This would, however, have additional equity implications.

Equity

As noted earlier, the Better Super reforms achieved significant simplicity, with some trade-off at the expense of equity.

Essentially there are two separate issues relating to equity:

- Low income earners receive little taxation support;
- The taxation support for high income earners is very generous – in all areas: contributions tax relief, low/nil investment tax and zero tax on benefits payable after age 60.

The former arises as a result of the imposition of the 15% tax on super fund contributions and investment income.

The latter arises largely as the inevitable but natural consequence of the progressive income tax system providing a higher rate of tax relief for higher rate taxpayers.

[2] Tax Expenditure 2008/09 (Treasury 2008 Tax Expenditure)

Tax Rates for low income earners

The flat contribution tax of 15% provides little in the way of a concession to low income earners while providing substantial benefits to high income earners.

Taxable Income ($)	9% Contribution ($)	PAYG tax (%)	Contributions Tax (%)	Current Net Tax Concession (%)	Current Net Tax Concession ($)
20,000	1,800	16.5	15	**1.5**	**27**
60,000	5,400	31.5	15	**16.5**	**891**
100,000	9,000	41.5	15	**26.5**	**2,385**
200,000	18,000	46.5	15	**31.5**	**5,670**

It may be argued that the equity of the contribution tax arrangements for low income earners should include the availability of the co-contribution.

However, the reality for most low income earners is that they are unable to benefit from the co-contribution as they are do not have the disposable income to make additional contributions. The co-contribution is more likely to be used by households with higher disposable income (but where one member of the household has a lower income).

High Income earners

Data on the distribution of superannuation contributions and assets is scant. The table below shows the results of some modelling based on reasonable assumptions.

Measure	Bottom 25% of Earners	**Top 25% of Earners**	**Top 10% of earners**
Share of SG contributions	9%	53%	29%
Share of Salary Sacrifice	0%	80%	49%
Share of Assets	6% (pre retirement) 0% (post retirement)	57% (pre retirement) 67% (post retirement)	32% (pre retirement) 37% (post retirement)
Share of Tax Expenditure	<2%	68%	45%
Amount of Tax Expenditure (2008/09)	<$0.5bn (out of $24bn)	$17bn (out of total $24bn)	$11bn (out of total $24bn)

Source: Darren Wickham Presentation to Super Policy Forum 19 February 2009

These figures are consistent with the observation in the consultation paper that 5% of individuals account for 37% of concessional contributions.

The 2007 Intergenerational Report revealed that 25% of the population will not receive the Age Pension (a proportion that will remain relatively stable over the next 40 years).

One of the aims of tax concessions is that superannuation will reduce future Age Pension outlays. The table above shows that a large majority of tax concessions are being provided to the top 25% of individuals who are unlikely to receive the Age Pension, as it is expected that they would save without tax concessions.

While their effect is yet to be felt, the Better Superannuation contribution limits will, over time, improve equity in relation to superannuation tax concessions.

Compensation for locking money away

One commonly stated rationale for tax concessions is that they provide compensation for the inconvenience of having money locked away (via preservation) until retirement. Determining the appropriate level (if any) of compensation is highly a subjective task.

However, it is arguable that low income earners are considerably more inconvenienced than high income earners by preservation, as they are more in need of money now to pay for the necessities of life.

In other words, compensation for preservation should ideally be highest for low income earners. The analysis above, however, shows that the compensation is actually the other way round, that high income earners are being considerably better compensated than low income earners for having money locked away.

Adequacy of Retirement Incomes

Our retirement income system has traditionally supported the target of incomes in retirement which should be broadly commensurate with pre retirement incomes – for at least all but the rich. We support the continuance of this target.

Effective tax relief on employer contributions and tax relief for self employed and non employed deductible contributions are major parts of the structure to provide this outcome.

Improving equity in contributions taxation

The Institute is not recommending any specific levels of taxation, nor does it wish to suggest to what degree a tax subsidy should be provided to different income groups. Rather, we wish to provide the Review Panel with three possible alternative structures for improving the equity in contributions taxation. The Government can modify the parameters within these structures to achieve the desired level of equity / incentive

Option 1. Co-Contribution for Employer contributions for low income earners

The impact of the 15% contributions tax on low income earners could be ameliorated by introducing a co-contribution for their employer contributions. This could operate using the reporting infrastructure currently used to determine co-contributions applicable to undeducted contributions.

Option 2. Tax Rebate through the PAYG System

For low income earners all (or part) of the 15% contributions tax could be refunded through the PAYG system (instead of through the superannuation fund). Instead of an exactly matching with the employer contributions received, a rebate could be provided based on income earned as an employee and assumed contributions.

The cost of either Option 1 or 2 is estimated to be no more than $1bn

Option 3. Tax contributions through the PAYG system and not in the super fund.

This involves:

- Scrapping the 15% contributions tax (ie nil contribution tax)
- Making all contributions payable out of after tax income (ie deduct PAYG on total income)
- Providing rebates or deductions, tailored to provide a desired level of incentives (funded from the increased PAYG revenue)

There are several advantages in this approach

- It provides a mechanism for rebalancing the cost of tax concessions away from high income earners towards low income earners.
- Any tax concessions (in the form of rebates or deductions) are more transparent and measurable, and can be adjusted in the future without the need for transitional arrangements or "grandfathering".
- The rebates / deductions can be better tailored to provide incentives in certain income ranges or limit the cost of concessions at certain income levels
- It would simplify the administration of tax from a superannuation fund perspective (there would be no contributions tax to administer)

Improving equity in investment taxation

The Government could consider a review of the exemption of the taxation of investment income on assets supporting pension liabilities ie taxing investment income on pension assets on the same basis as accumulation assets.

There are a number of advantages in this approach.

- The additional revenue could be used to fund tax measures for low income earners.
- The increase in tax is more likely to impact high income earners - lower balance members are more likely to take benefits as a lump sum: the larger the balance, the more likely to be taken as a pension.
- This measure claws back some of the windfall gain from the removal of benefits tax due to Better Super
- It simplifies taxation from an superannuation administration perspective
- It removes the anomaly of Capital Gains Tax "Evaporation" which provides a comparative advantage to Defined Benefit funds and SMSFs (as they are more easily able to pass this on to members than Public Offer funds with their wide range of member investment options)
- It makes "Transition to Retirement" more of a genuine phasing of retirement and less of a tax minimisation strategy.

While it is acknowledged that such a measure would reduce pension payments derived from accumulated savings, the reduction could be offset either by lowering pre retirement investment tax rates or refocusing tax expenditure to provide more substantial co-contribution or tax other support during the accumulation phase.

One problem that arises under this approach is that the effective tax rates on alternative (non super pension) investments are likely to be quite low. This is because the amounts of earnings are often small, and also because of the concessional arrangements available to seniors (eg Senior Australians tax offset etc). This problem may be overcome by setting the tax rate at quite a low level.

Summary Recommendations:

- We have suggested 3 possible structures to make contributions tax more equitable.
- Make death benefits tax free
- Make all benefits tax free by aligning the Preservation Age and Tax Free Age
- Either abolish the abolish Age Limits on contributions or have a single maximum age (eg 75)
- Simplifying the system by removing the Contribution Splitting, Spouse Rebate, Children super provisions

4 A robust retirement income system

Q4.1 At what age should an individual be able to access their superannuation and at what age should they become eligible for the Age Pension?

Discourage/limit early access to lump sum retirement savings

According to OECD research, there is global evidence that the earliest ages at which retirement benefits can be first accessed remains an important determinant of retirement decisions[3] and allowing early withdrawals leads to low retirement incomes[4]. Also, allowing unlimited access to retirement savings prior to Age Pension Age is inconsistent with a means tested Age Pension.

Under current legislation it is possible to retire and access unlimited superannuation benefits from preservation age (55, increasing to 60), with tax free benefits also provided after age 60. This benefit can then be used to fund living expenses to age 65 at which time an individual may access the Age Pension (subject to the means test).

Allowing unlimited access to retirement savings prior to Age Pension age has the potential to encourage early retirement and the retention of higher mortgage debt into later years. The Consultation paper (December 2008, page 37) noted that the proportion of seniors (55 years or older) carrying mortgage debt doubled from 7% to 15% in the 10 years to 2005-06.

We recommend that the Government consider some restrictions on access to lump sums, especially prior to age pension age..

Possible options to achieve this are as follows:

a. Retain preservation age at 60 but limit annual withdrawals from preservation age to Age Pension age to the lower of a percentage of account balance (for example the 10% maximum transition to retirement limit) and a nominal lump sum limit (for example $20,000).

b. Gradually increase the tax-free age for superannuation benefits to the Age Pension age. An increase in the tax-free age does not mean that retirees are unable to access part of their superannuation before this age on a tax-free basis. After all, retirees between preservation age and the tax free age are able to receive a lump sum benefit of up to $145,000 (2008-09 amount and indexed thereafter) with no tax payable on the benefit.

Another option would be to include those superannuation assets withdrawn prior to Age Pension age, in excess of the 10% maximum transition to retirement limit and a nominal lump sum limit (for example $20,000), in the assessment of assets under the Age Pension test for a limited number of years (for example, five years) in a manner akin to the current gifting rules. This option has the benefit of linking subsequent Age Pension payments with the taking of excessive lump sums prior to Age Pension age, but may be slightly more complex than simply using limits or tax to achieve the same effect.

Another option would be to gradually increase both preservation age and the tax free age to the Age Pension age. However, this option could potentially disadvantage those people for whom early retirement is not an option.

[3] OECD, Ageing and Employment Policies, Live Longer, Work Longer, 2006 p57

[4] OECD, Pensions in Asia/Pacific, 2008

Standardised all age based rules for contributions

Currently, the superannuation system delivers a very confused message about "retirement age" as there is no consistency in any of the age based rules for contributions and benefits. For example:

a. The preservation age (i.e. the age at which you can access your superannuation) is increasing from age 55 in 2015 to age 60 in 2024;

b. Retirement benefits paid from a taxed superannuation fund are tax-free from 1 July 2007, providing the member is aged 60 or over;

c. No work test is required for fund members to contribute to superannuation before age 65;

d. Similarly, the ability of members to contribute up to $450,000 of non-concessional contributions in a single year (i.e. the equivalent of the limit for three years) is only available up to age 65;

e. The SG requirements for employer contributions only apply to employees under age 70;

f. Spouse contributions are only permitted if the member's spouse is under age 70;

g. The Government's co-contributions are only available for employees aged 70 or less at the end of the relevant financial year; and

h. Superannuation contributions can be made up to age 75, subject to the work test.

The Federal Government should standardise the age based contribution rules and enable all contributions, whether employer, employee, self-employed, co-contributions and spouse contributions, to be paid at any age provided that the person is no more than 10 years older than the Age Pension age. At the moment, this would be age 75 for males, which is consistent with the current contribution rules.

Age Pension age

The eligibility age for the Age Pension in Australia has remained at 65 for males since its introduction in 1909. The Age Pension age for females was decreased to 60 in 1910 but is now being increased gradually to 65.

In the context of the relatively stable life expectancy for older Australians that existed in the first six or seven decades of the 20th century, an unchanged Age Pension age seems reasonable.

However, in the present day context of an ageing population and increasing healthy life expectancies for 65 year olds, the Institute believes that it is appropriate to review the Age Pension age to consider whether any gradual increase in this age is warranted to reflect increasing life expectancy and health and capacity to work.

Our previous submission (dated September 2008), outlined reasons why an increase in Age Pension age should be considered. In particular the Age Pension age could be increased from, say, 65 to 67 between 2025 and 2032. This would go some way to removing the community's focus on a single age 65.

Retirement is not always voluntary - some groups (particularly manual workers) retire early because they can no longer work. Increasing the Pension Age for this group will not keep them in work longer. Rather, it will force them to either access a Disability

Pension or their own superannuation. Any proposed increase in the Pension Age needs to also consider the implications for accessing other income both public and private.

Q4.2 What is the role of individuals in dealing with investment and longevity risk in accumulating and drawing down their retirement income? Do financial markets provide the means to deal with these risks? If not, is there a role for government to address these shortcomings?

Ability of individuals to deal with longevity risks

Australia's retirement incomes system is based on individual accumulations and a modest, publicly funded, means tested Age Pension. However, accumulation based superannuation puts adequacy, investment risk and longevity risk into the individual's hands. Consequently, many people will outlive their accumulations and the Age Pension alone, may not be sufficient to provide them with an adequate income.

Some relevant facts:

a. 80% of those aged 65 and over (only reducing to 75% in 2047[5]) already receive a lifetime annuity from the Age Pension (Pillar 1).

b. Typical retirement payouts are not high for the foreseeable future, being around $70,000[6] in 2005-06 and only expected to gradually increase to around $200,000 under a mature superannuation guarantee system over the next 20 or so years.

c. Consequently, the Age Pension (Pillar 1) is, and will remain, a significant proportion of retirement expenditure for retirees, being 79% in 2010 and only reducing to 50% in 2040[7] for a person of median income (where median income is approximately 75% of AWOTE or $45,000 per annum).

d. Also, the dependency on the Age Pension increases with time. The percentage of people receiving the full Age Pension increases from just over 50% at age 65 to around 85% at age 85.

e. The 20% (increasing to 25%) of retirees who do not receive the Age Pension are the wealthiest retirees. Given the projected increase in the total population aged 65 and over in Australia (from 2.7 million to 7 million[8] individuals from 2007 to 2047), self funded retires are expected to increase from just 0.5 million to 1.75 million in 2047. However, many of these self funded retirees will be unconcerned by the risk of outliving their savings as increased longevity only affects the size of their bequest on death.

The recent economic times, where retirees have lost considerable savings due to poor investment markets, highlights the diversification benefits of the current arrangements, in that the Age Pension has increased to at least partially compensate for loss of assets.

In regards to longevity based products, there is no current demand for the purchase of these products by retirees. This is likely to be due to both the unattractiveness of the product and a lack of "need", either perceived or real, by retirees.

a. Longevity insurance products, in particular lifetime annuities, are currently unattractive to retirees for a number of reasons including:

[5] Intergenerational Report 2007 and Retirement and Income Modelling Unit Department of Treasury, The Adequacy of Australian Retirement Incomes – New Estimates Incorporating the Better Super Reforms, 2007

[6] The Age Pension, superannuation and Australian retirement incomes, ASFA 2008

[7] Australia's future tax system Retirement Income Consultation paper, 2008

[8] Intergenerational Report 2007 p6

i. The need to pay large amounts of capital to providers up-front and the risk of institutional failure with long term contracts

ii. The inflexibility to access this capital if circumstances change

iii. The loss of capital on premature death

iv. The perceived poor return on their "investment", which reflects both the relatively low interest rate regime we have experienced in recent years, a lack of understanding of longevity and the need for insurers to service both formal and risk-based high capital adequacy requirements.

b. However, even if these product features were resolved, the need for lifetime annuities is expected to remain low for the foreseeable future, given that most retirees will already receive a significant portion of their retirement income as a lifetime pension (from Pillar 1) and will have relatively low levels of retirement savings.

At this stage, we do not favour the forced purchase of annuities (compulsory annuitisation) for the following reasons:

a. Retirees need flexibility to access a certain amount of capital in order to meet potential lump sum payments for mortgages, health and/or living/aged care costs.

b. In addition, the purchase cost for even a relatively small lifetime annuity of $10,000 per annum is likely to be at least $200,000[9].

c. Therefore, given the relatively low level of projected retirement savings for the foreseeable future, any forced purchase of lifetime annuities for savings over a nominal limit (say $100,000 to allow for lump sum needs) will only result in many small, inefficient annuities for the vast majority of retirees and over-annuitisation of wealth, particularly for lower income groups.

d. The forced purchase of annuities also assumes people retire only once from the workforce, as once commenced, lifetime annuities can be difficult and expensive to commute and restart. Lifetime annuities do not work well in an era when people are increasingly moving in and out of the workforce during their older years, which is a trend that we should be encouraging.

e. People need incentives to save for retirement and the forced purchase of annuities for savings over and beyond a certain nominal limit may impact peoples desire to voluntarily save beyond this limit.

In place of the forced purchase of lifetime annuities, our preference would be to:

a. Limit lump sum withdrawals, which would leave retirees with some flexibility, whilst discouraging unlimited lump sum withdrawal during their retirement years.

b. Minimise or remove any barriers to the development of sound, annuity style products and voluntary purchase of these products.

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[9] Based on recent quotations for a 65 year old male single life indexed pension

Ability of financial markets to deal with longevity risks

The attractiveness of annuity products could be improved if insurers were able to reinsure their longevity risk, reduce the need to hold capital to support these risks and to pass the investment mismatch risk to individuals. This would require structural change along the following lines:

a. Provision of mortality swaps or longevity bonds to allow insurers to share or eliminate their exposure to longevity risk

   i. Conceptually, some capital markets participants could find it attractive to accept longevity risk for an appropriate price. For example, investors could be attracted by low correlations with returns from other markets, or - life insurers who are exposed to mortality risks and annuity providers who are exposed to the complementary longevity risk may regard themselves as natural hedge counterparties.

   ii. There have been limited attempts internationally to develop such products with only partial success. A mortality bond successfully issued by Swiss Re involved principal repayments linked to a mortality index based on mortality rates in five countries. However, a longevity bond, launched by the European investment Bank and BNP Paribas, was withdrawn before being issued. The bond was designed for UK pension funds and was an annuity with payments linked to the number of the cohort of English and Welsh males aged 65 in 2002. In particular the very long term nature of the risks (30-40 years or more) has not been adequately dealt with by products developed to date.

   iii. In Australia, the size of our market and population may make it difficult to achieve adequate risk diversification without the Government or other party enabling some form of population-wide coverage. At the very least, the development of appropriate mortality or longevity indexes will require access to data held by government agencies.

b. Pooled life funds (e.g. tontines)

   i. These products involve groups of retirees pooling their longevity risk. Essentially the “survivors” benefit from the capital released by participants who die earlier.

   ii. This passes most of the longevity risk back to the retirees reducing the capital requirement of the product issuer.

   iii. We note that there may be similar problems obtaining a meaningful mass into a pool within Australian market in order to achieve adequate risk diversification.

c. With profits, variable or unit linked annuities

   i. These products allow issuers to invest in a wider range of assets such as equities by passing the investment risk and opportunity for reward to individuals.

   ii. This is a risk that they are already required to take on and manage under alternatives such as account based pensions to take on investment.

d. Inflation-linked bonds

   i. Most retirees need an income that maintains its purchasing power during potentially long periods in retirement. This suggests income streams should be indexed to some measure of inflation (such as the CPI) or wider measures of community living standards such as GDP growth or wages growth (AWE).

ii. As noted above, the availability of investments which provide a direct hedge against inflation is very limited in Australia, and those investments which are available are of much shorter duration than the likely period spent in retirement.

There are other legislative barriers to product development in this area, such as:

a. The Sup*erannuation Industry (Supervision) Regulations* are overly prescriptive and narrow in the type and form of pensions that are investment tax exempt and do not allow for variation of income payments each year beyond inflation.

b. The rules for assessing income for the Commonwealth Seniors Health Card (CSHC) and assets for an aged care bond may disadvantage the purchase of lifetime annuities.

The role of Government

Government can play many different roles in the provision of effective annuity/income stream products ranging across:

a. Acting as a longevity risk reinsurer or pooling facilitator for product providers that leverage off its population-wide coverage, a coverage not available to individual or individual institutions

b. Issuing capital instruments or guarantees with the same effect to allow private sector providers to issue new products, and

c. Acting as a product provider to individuals in areas where there is no private sector market

d. Ensuring the regulatory environment is as efficient as possible and does not impose unreasonable constraints on the development of innovative new products.

Some examples of these roles are as follows:

a. Government issuing inflation linked bonds with durations consistent with life expectancies and/or longevity bonds in order to support capital market product development.

i. Financial service providers (insurers, banks and super funds etc) could then use these building blocks to innovate and create product, without existing high level of capital.

ii. Offshore providers may be attracted by such market developments and act to broaden competition.

iii. The Future Fund may provide a means to limit increases in net liabilities.

iv. The disadvantage is that the Government takes on additional population longevity risk, albeit, the risk could be mitigated by limiting either quantum or age. To the extent that such assistance forestalls retirees taking up the Age Pension, there may be a replacement effect as opposed to a net increase in risk.

v. There may also be issues of equity given that the better off retirees would initially be the buyers of such products.

b. Government allowing individuals to purchase the Age Pension

   i. Given the lack of availability of lifetime pensions from the private sector, another option may be to allow individuals to purchase an Age Pension (or multiples thereof) from the government from an advanced age, say 85, in return for premiums paid to the Government (either lump sum or from an earlier age).

   ii. The option already exists for people on a part Age Pension to purchase up to the full Age Pension using real estate as security.

   iii. This option would allow individuals to purchase annuities in excess of the full Age Pension from the government.

   iv. Again, this would mean the Government taking on additional population longevity risk over that which they already have.

   v. Also, this option could easily crowd out capital market product development.

In our view:

a. Government should ensure that the regulatory environment is conducive to sound product development. The number of different regulators (ATO, ASIC, APRA and DFACS), who are involved in any new product development, often with conflicting goals, makes this difficult in the current environment.

b. Government should not provide product that is better met by the private sector market.

It is clear that the Government is and will remain the primary longevity insurer for the majority of retirees for the foreseeable future. Hence:

a. Most retirees are already protected from longevity risks to the extent that the Age Pension provides an acceptable standard of living.

b. It is difficult to see how there could be a sufficient market in lifetime annuities, even if they were made compulsory, for insurers to adequately diversify their longevity risks.

For this reason, we have taken the view that it would be better and more realistic to focus the government role on being the longevity insurer for later ages through the age pension only and allow the markets to provide products more suited to earlier ages and known time periods.

Accordingly, we have put forward the option of a deferred Age Pension (see section 6). This is a voluntary option for increasing both the average retirement age and the level of the Age Pension, which allows both the Government and individuals to better manage their longevity risks.

A deferred Age Pension achieves the following:

a. The needs of individuals change from managing their financial resources and/or work for an unknown period of time to managing such resources for a known period of time don't really understand this?

b. Companies can therefore focus their product towards managing financial resources with the investment and term risks for shorter and known periods of time. This involves considerably less capital and risk and therefore more palatable for shareholder driven companies that may be reluctant to reserve for unknown contingencies of life expectancies.

c. The government's existing longevity insurance changes from providing a lower Age Pension for longer periods to providing higher Age Pensions from later ages. This will cost the government more if mortality improves fatser than expected in the conversion rates.

Role of housing equity as third pillar against longevity risk

Given the relatively modest level of projected retirement savings and the resulting reliance on the Age Pension, we would not expect that retirement savings will be sufficient to meet anything other than basic living costs for most Australians.

However, older Australians have a high level of home ownership with 89% of couples and 77% of singles over age 65 owning a home[10]. Consequently, older Australians are asset rich and income poor compared to the wider population.

Given that older Australians are likely to face significant costs for health and/or aged care in addition to their basic living costs, their ability to access home equity for this purpose will be essential.

The release of home equity can be achieved through either downsizing or utilising home equity release products, which include reverse mortgages, home reversion or shared appreciation mortgages.

In our view, the safe and efficient release of home equity should be encouraged.

Currently a major impediment to retirees releasing home equity, whether through downsizing or home equity release products, is the impact on the Age Pension. As owner occupied housing is exempt from the assets test, any release of housing equity is likely to result in a reduction in retirement income.

Given the alternative, which is the current situation where retirees continue to retain this important source of funds locked up in their house, consideration should be given to maintaining some level of exemption that applies to owner occupied housing under the Asset test to any release of home equity, where the equity is released into a protected savings account or superannuation account, where it can only be used for funding health, retirement or aged care.

[10] ABS 6554.0 Household Wealth and Wealth Distribution, Australia, 2003-04.

5. A simple and approachable retirement income system

Q5.1 In what ways does the retirement income system impose undue complexity and cost on retirees and workers? How could this complexity be reduced?

The Institute is of the view that the current pension means testing regime is both distorting and highly inefficient. It recommends that earned income be removed from the means test and that simpler rules be applied to assets, with a view to both reducing complexity and improving labour market participation amongst older workers.

To assess the financial impact of continuing to work and earn an income post Age Pension age, a retiree currently needs to determine:

a. The reduction in the Age Pension due to earned income

b. The marginal tax rates payable on earned income after taking into account personal tax rates less the following four tax offsets, all of which operate at different and over-lapping income levels and ages:

   i. The Low Income Tax Offset

   ii. The Pensioner Tax Offset

   iii. The Senior Australian Tax Offset

   iv. The Mature Age Worker Tax Offset.

The table below shows the marginal tax rates that would apply to earned income for:

(a) A person of under Age Pension age who is not in receipt of any type of pension

(b) A person of Age Pension age who is self funded (that is, not in receipt of the Age Pension)

(c) A person of Age Pension age who is in receipt of the Age Pension and whose income (including earned income) exceeds their "income free" threshold and therefore, the Age Pension is being reduced by 40c per dollar of income earned.

Income p.a.		Person under Age Pension age(1)	Self funded retiree(2)	Age Pensioner(3)
From	*To*			
0	3,432	0%	0%	0%
3,432	11,000	0%	0%	40%
11,000	27,685	15%	0%	40%
27,685	30,000	15%	27.5%	56.5%
30,000	39,351	34%	46.5%	67.9%
39,351	43,707	34%	46.5%	46.5%
43,707	48,750	34%	34%	34%

48,750	53,000	30%	30%	30%
53,000	63,000	30%	35%	35%
63,000	75,000	30%	30%	30%

(1) Marginal tax rates based on personal tax rates for 07/08 less Low Income Tax offset

(2) Marginal tax rates based on personal tax rates for 07/08 less Low Income Tax offset, Senior Australian Tax Offset (in place of the Pensioner Tax offset) and the Mature Age Worker Tax offset.

(3) Marginal tax rates based on personal tax rates for 07/08 less Low Income Tax offset, Senior Australian Tax Offset (in place of the Pensioner Tax offset), the Mature Age Worker Tax offset and the reduction in the Age Pension as a result of earned income.

(4) We note that these marginal tax rates do not factor in any taxation benefits that may be gained from transition to retirement income strategies and in particular, salary sacrifice arrangements, nor the potential benefits of the current Pension Bonus scheme. Both of these options have the potential to reduce the marginal tax rates but not everyone of over Age Pension age have these options available to them. We have also not included the additional cost of losing the Pensioner Concessional Card, which would occur if earned income was sufficient to result in the total loss of the Age Pension.

The impact of this confusing system of Age Pension reductions, personal tax rates and tax offsets is that firstly, it is extremely complicated for a person of Age Pension age who is in receipt of the Age Pension to even know the "cost" of earning additional income. Secondly, the high marginal tax rates on earned income are likely to block any desire to work beyond Age Pension age.

Given that older people are not necessarily richer or poorer than other members of the tax paying community, there should be greater consistency in marginal tax rates.

The Income test penalises work beyond Age Pension age, which runs counter to the Government's objectives and to the mindset it wishes to encourage. The OECD noted in their 2006 report[11] that less than 18% of people in the 65-69 group in Australia work compared to 30% in the US, where there is no earnings or mean test for pensioners after full-retirement age.

The Income test was never even designed to cope with earned income. A Department of Parliamentary Services Research Brief prepared in November 2005 commented as follows:

> *"The method of assessing a person's pension entitlements under the income test, based on their annual rate of income, allows Centrelink to assess their current need for income support. But it was also introduced, when most age pensioners did not work, and when it was not the Government's intention to increase older workers' participation in the workforce."*

There would be significant administrative and efficiency advantages in the operation of the means testing regime and improvements in the behavioural and financial incentives to keep working, if earned income was removed from means testing, in which case far simpler means testing rules could apply to assets.

[11] OECD, Ageing and Employment Policies, Live Longer, Work Longer, 2006 p59

6. A sustainable retirement income system

Q6.1 The Age Pension serves two roles, as a safety-net for individuals who are unable to sufficiently save for their retirement and as an income supplement for many individuals who do save. What should be the role for the Age Pension and means testing in a future retirement income system and what impact does this have on its sustainability into the future?

The Age Pension serves both roles, that of a safety net and as one of the three primary pillars of retirement income. With 80% of those aged 65 and over (only reducing to 75% in 2047[12]) relying on all or part of the Age Pension, the Age Pension will remain a primary pillar of retirement incomes for many decades.

Treasury projections[13] indicate that the Age Pension is affordable at current levels, (being less than 5% GDP), however, affordability will be in question if the Age Pension is increased, for example, to address any shortfall for singles compared to couples and any overall shortfall relative to modest standards of living, especially if longevity also continues to increase.

Means testing the Age Pension

The key advantage of means testing an age pension is to target financial resources. In theory, this should ensure that the age pension can be set at an “adequate” level, whilst keeping projected costs affordable as a percentage of GDP.

The key disadvantage of means testing an age pension is the potential for abuse and manipulation, high administration costs, an undesirable level of intrusiveness and disincentives for self provision.

In addition, due to the heavy reliance by older Australians on the Age Pension:

a. The eligibility criteria and means testing rules exert a major influence on the decisions and behaviours of older Australians

b. The Government, as the major underwriter of longevity insurance for most Australians, gains or loses from these decisions and behaviours.

The current rules regarding both the Income test and the Asset test for the Age Pension are complex and expensive to administer. High levels of error and welfare fraud have been reported over the years.

By removing earned income from means testing, the means testing rules revert to being based on assets only, which also removes the need to deem income on assets.

A simplified assets test could be formulated to take into account both the current limits on assets as well as the current limits on deemed income (which forms part of the existing Income test).

The removal of earned income from means testing is akin to paying universal pensions for specific levels of assets. This retains the key advantage of means testing (targeting scare resources) whilst minimising the key disadvantage (e.g. high administration costs).

[12] Intergenerational Report 2007 and Retirement and Income Modelling Unit Department of Treasury, The Adequacy of Australian Retirement Incomes – New Estimates Incorporating the Better Super Reforms, 2007

[13] Intergenerational Report 2007

Means testing based on assets only, is considerably easier to administer and less intrusive.

a. In order to ensure that 80% of the means testing effort is expended on 80% of the assets, it may be possible to reduce the reporting requirements to a less regular frequency, unless there has been a material change in circumstance.

b. It may also be possible to combine the reporting of assets to Centrelink with the reporting of income tax to the ATO. This would reduce the reporting requirements and obligations on retirees and potentially reduce the risks of retirees hiding assets, as it will require them to also hide any income from any undeclared assets.

If the Income test is removed, there will be increased pressure on the Asset test, as it will be the sole determinant of the Age Pension. This may potentially increase the risk of people attempting to "hide" assets. However, there are clear advantages for people to hold assets in superannuation, which makes assets more difficult to "hide".

Other reform options considered but not pursued

Other options for Age Pension reform have been proposed from time to time. Some of these are briefly discussed here, for completeness. They have varying degrees of practicality, either operationally or politically.

Universal Age Pension (no means testing):

a. An option that has been raised in the past as an alternative to means testing the age pension in order to target those in need and to control the costs, is to pay the Age Pension universally (subject to age and residence criteria). Costs would be controlled to the extent that tax rates are set to recoup payments to higher income earners.

   i. It would be difficult to set tax rates high enough to recoup Age Pension payments to those who have sufficient other income, but not too high as to unreasonably discourage continued working.

   ii. Also, it would be difficult to allow for assets, other than income producing assets, through the income tax mechanism and possibly inefficient as you are paying the Age Pension out and then recouping through the tax system.

b. Another option would be to pay the Age Pension universally, with no special recognition through an income tax mechanism, but seek to recoup from the wealthy on death through a 'death duties' regime. This could have an advantage of implicitly recognising the value of the family home.

   i. However, there would be significant administrative complications in dealing with issues such as gifting, separation and divorce of pensioner couples, death of one member of a couple and remarriage of the other.

   ii. Also, any introduction of "death duties" is likely to be extremely unpopular.

Cap the value of owner occupied housing which is exempt under the Asset test:

a. Another option is that the maximum value of the home to be exempt under the Age Pension Asset test could be subject to a "cap" in order to encourage use of home equity. This cap could be set at a very high level e.g. $2m.

b. Although this option might have some appeal, it could necessitate a home valuation as part of every Assets Test (for home owners). Alternatively, the Valuer-General's valuation for rating purposes could be used as a best estimate, so long as there is a reasonably consistent valuation approach, on an 'improved property value' basis, used in each state.

c. The application of such a scheme would have to be considered on the basis that the compliance and/or political costs may well be in excess of the budgetary savings likely to be generated and the degree to which the exclusion of the family home distorts Age Pension applicants' behaviour.

One off means test:

a. Another option which has been previously canvassed is to make the means test a one off test, at the time of initially applying for the Age Pension.

b. Difficulties to be dealt with include the moral risk of arranging assets at one point in time and coping with change in circumstances, such as varying work patterns work, after the initial assessment.

Compulsory use of assets before Age Pension commences:

a. The option of forcing the use of all assets first prior to commencing the Age Pension was also considered.

b. Again, there is a higher risk of hiding assets or poor management of assets, given that the payment of the Age Pension is an all or nothing decision, as long as assets exceed the specified threshold.

c. By comparison, the Deferred Age Pension scheme provides voluntary encouragement for using assets first, prior to commencing an Age Pension.

Replace Age Pension with Disability pension:

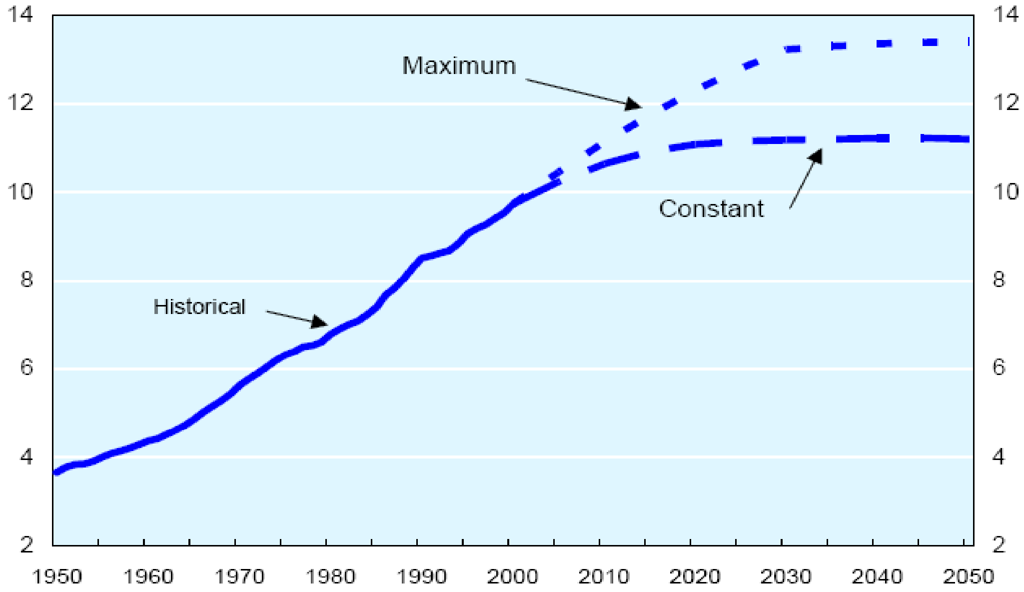
a. Finally another option which has been previously canvassed is to remove the Age Pension entirely and simply have the disability pension as a source of income in retirement.

b. The disadvantage of this option is that it would require the elderly to prove disability on an ongoing basis (otherwise it becomes a universal pension) and this is likely to outweigh any advantage gained from removing the concept of a retirement age.

Q6.2 In what ways does retirement income policy affect workforce participation decisions and what, if any, changes might reduce disincentives to work? Does the sustainability and cost of the retirement income system affect the workforce decisions of younger generations of workers?

With the ageing of the population, increasing workforce participation among older workers will become increasingly important if economic growth is to be maintained. The chart below shows the potential impact of workforce participation on the Australian labour force.

Projections of the Australian labour force under various scenarios (millions)[a]



a) The constant scenario assumes that current participation rates by five-year age group and gender remain constant over the period to 2050, The maximum scenario applies the maximum participation rates (for older workers 50 and above) in the OECD area by five-year age group and gender from 2030 to 2050, with a gradual adjustment over the period 2000-2030 to reach these maximum rates.
Source : OECD, *Ageing and Employment Policies: Australia.*

There is general acceptance that a range of initiatives, which improve population, participation and productivity, will be required to meet the challenges of our ageing population.

Currently, people are retiring well before the Age Pension age. The average age at retirement for people aged 45 years or more and who retired in the last five years was 61.5 years for males and 58.3 years for females[14], which is substantially lower than the Age Pension age of 65 for males and 63.5 for females. This is also reflected in a significant reduction in workforce participation rates for Australians over age 55. For example, male workforce participation rates reduce from 90% for 25-54 year olds to 66% for 55-64 year olds[15].

The OECD paper Live Longer, Work Longer[16], stated that "if working longer is to be an attractive and rewarding proposition for older workers, action on both the demand and supply side will need to be taken in co-operation by government, trade unions and civil society". The actions listed by the OECD paper were as follows:

a. Provide strong financial incentives to carry on working

b. Eliminate subsidised pathways to early retirement

c. Provide employers with stronger incentives to hire and retain older workers - through wage-setting and employment practices

d. Provide older workers with help and encouragement to improve their employability

[14] Australian Bureau of Statistics, 1301.0 - Year Book Australia, 2007

[15] Productivity Commission, Workforce Participation Rates – How does Australia Compare? Staff Working Paper 2006

[16] OECD, Ageing and Employment Policies, Live Longer, Work Longer, 2006

e. Change the attitudes of both employers and older workers themselves.

We recommend that unlimited access to lump sums from preservation age be strongly discouraged as this provides a subsidised pathway to early retirement.

We also recommend that there should be clear and strong financial incentives to carry on working in older ages. Therefore we need to remove the current financial disincentives on remaining in work.

a. An implicit tax on remaining in work is where a person who would otherwise be entitled to an Age Pension, elects to keep working (and paying taxes), but is not compensated by a higher Age Pension. The current Pension Bonus scheme is restrictive and only provides retirees with around half the value of the pension they have foregone.

b. Secondly, where a person who would otherwise be entitled to an Age Pension, desires to keep working, the high marginal tax rates on earned income will block any desire to work beyond Age Pension age.

Once inactive, older people are unlikely to shift back into active work (less than a 5% chance[17]), hence the need to encourage people to remain active in the first place.

Introduce a deferred Age Pension, remove earned income from means testing and simplify the mature age tax offsets

Society, as a whole, will benefit from measures designed to encourage older Australians to support themselves financially for longer and to a greater extent than is currently the case, through a combination of work and savings and/or family support.

A voluntary option to provide a financial incentive to carry on working is to introduce a Deferred Age Pension, remove the earned income test and simplify the complicated system of existing "mature age" tax offsets into one simpler "mature age" tax offset.

Under this approach:

a. A person's entitlement to all or part of the Age Pension would be determined each year by a simplified Asset test.

b. A person eligible for all or part of the Age Pension could choose to either "take" or "defer" their Age Pension.

c. If the person "takes" the Age Pension there would be no further reduction to the Age Pension as a result of any earned income, however, the tax rates that would apply would be the same as that applied to any other member of the community. That is, any person taking the Age Pension would not receive a "mature age" tax offset.

d. If the person "defers" commencing all or part of their Age Pension, they would receive an increased Age Pension when subsequently commenced. However, they would receive the "mature age" tax offset during the deferral period, which would reduce the tax payable on any income earned during the deferral period and they would also retain all other pension rights during the deferral period, such as the Pensioner Concession Card.

e. The period of deferral would be totally at the person's choice and there would be no limit on the deferral period.

[17] OECD, Ageing and Employment Policies, Live Longer, Work Longer, 2006 p36

f. The rate of increase to their Age Pension entitlement could be determined on an actuarial and financially neutral basis (i.e. on a 'no loss' basis for the Government and individual). Initial work suggests that equivalence in value would support a rate of increase of around 5% to 8% for each year of deferral (the calculation could be done on the basis that the Government, on behalf of the taxpayer, benefits from mortality). Based on a 7% per annum increase, the full Age Pension for a single (homeowner) would increase in deferral from:

   i. $14,368 per annum from age 65 to

   ii. $20,000 per annum from age 70 to

   iii. $28,000 per annum from age 75.

g. The current and complicated system of tax offsets should be simplified so that all offsets that apply to older people are combined into one "mature age" offset that applies to self-funded retirees only, which includes Age Pensioners in deferral.

h. The scheme would replace the current, but restrictive, lump sum Pension Bonus system. However, a person could continue to access a lump sum up to the maximum of the existing Pension Bonus scheme, for example up to $33,409 after five years for a single, instead of the increased Age Pension and could also receive this payment on death prior to commencement of the Age Pension.

The benefits of this Pension Deferral scheme are as follows:

a. The scheme provides a voluntary approach to increasing the average retirement age, increasing the level of the Age Pension and to use existing assets before commencing the Age Pension.

b. The current financial penalty that applies to people working beyond Pension Age, who would otherwise be eligible for an Age Pension, is removed.

c. The proposed increases in Age Pension on deferral would be financially neutral. Cant say this.

d. However, as a general rule, the Government would financially benefit from:

   i. Any individual that chooses to work, when they would not otherwise have done so, and then pays taxes during the period of deferral. (While the extra income earned will often involve a tax deduction to another tax payer, this will not always be the case and economic multiplier effects would ultimately likely result in a net economic and taxation gain.)

   ii. Mortality, that is, where people do not live to deferral age and the payment of the lesser Pension Bonus results in net saving to Government.

e. People are encouraged to use their own resources, whether work and/or assets, for longer. For example, a person aged 65 could plan to use a combination of work (subject to availability and health) and their existing savings to say age 70, at which time their Age Pension might be $20,000 per annum, which would represent a far more acceptable level of income.

f. The scheme allows individuals to plan and enables them to better manage their longevity risks. It is far easier for a person to manage their savings for a known period of time than the unknown period of their longevity. It is also easier for companies to provide product for known periods of time, that would help retirees to manage their savings.

g. By allowing the pension deferral to be for all or part of the Age Pension and for whatever period until subsequently claimed, the Age Pension can be better integrated with variable work patterns that are more and more common for older workers.

Potential other issues

The take up of a Deferred Age Pension will depend on the increase made to the pension in deferral, so this increase would need to be reasonable. People will weigh up the option of conserving their existing savings and taking a lower Age Pension now, versus drawing on their savings (and/or work) now, in order to have an increased Age Pension later, with the risk of a lesser payment on early death.

With the removal of existing tax offsets whenever the Age Pension is paid, existing Age Pensioners will be worse off. There may need to be some arrangement made for these Age Pensioners to ensure they would not be disadvantaged by the new arrangements. It might be possible that an increase in the Age Pension might counter some of the additional taxes payable.

There may also be a need to limit the income that can be earned whilst still taking an Age Pension. If the impact of the personal tax rates (given that there would be no "mature age" related offsets) are not in themselves sufficient to encourage deferral beyond a certain income point, it may be necessary to consider a tax surcharge on income over a set level, when the Age Pension is being paid and not deferred. Again, this would not be difficult to implement. However, given that in practice, the number of Age Pensioners that might be able to earn a high income will be low and they will be paying full tax anyway on their income, the administrative cost of any additional surcharge measure should be carefully weighed up against any perceived benefits.

Global experience

There are a number of countries which have reduced pension entitlements on early payment prior to a specified age and increased pension entitlements on deferral beyond a specified age.

Countries which offer increased pensions on deferral include United Kingdom (10.4% pa increase in deferral), United Stated (8% pa increase in deferral), Canada (6% pa increase in deferral), Germany (6% pa increase in deferral), to name but a few.

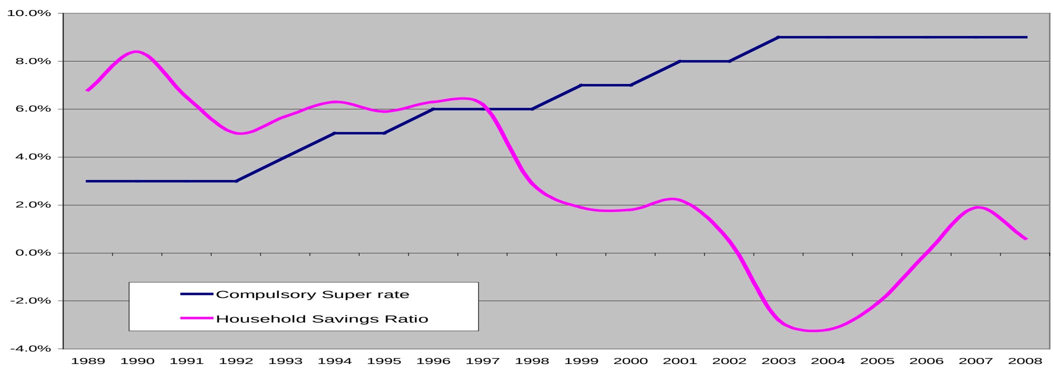
Costings

At this stage, we have not attempted to cost this option, given that it involves a number of potential changes to the tax offsets that affect all ages not just retirees, as well as the Age Pension and means testing rules. Detailed costings would require population data on income, savings and expenditure, plus sophisticated modelling to allow for various different parameters around the means testing rules and interactions between taxation and social security rules, plus the ability to test the changes in behaviours that would undoubtedly occur with any changes in policies.

Should costings be required, it is possible that the assistance of Treasury's Retirement and Intergenerational Modelling Unit would be essential in order to provide them within a relatively short period of time.

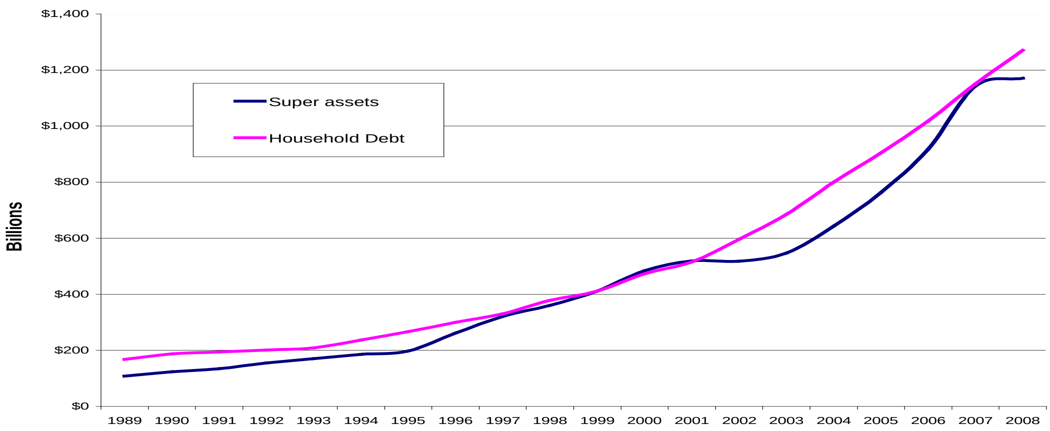
Q6.3 What impact could financial intermediation have on the effectiveness of retirement income policy?

One of the intended economic benefits of compulsory superannuation was to increase national savings. However, as the graph below illustrates, the rate of household savings has actually decreased since the introduction of widespread participation in superannuation



source: ABS 5204.0 Australian System of National Accounts

While the rate of superannuation savings climbed steadily over the past 15 years, households are saving less, primarily as a result of increased borrowings. The graph below shows the overall level of household debt compared to the level of superannuation assets.



source: ABS 5232.0 Australian National Accounts: Financial Accounts, APRA + ISC statistical bulletins, ABS 5650 (Assets of Superannuation funds)

In other words, increased savings through superannuation have been almost exactly offset by the increased level of household debt.

Research conducted by AMP and NATSEM in 2004 ("The Lump Sum: here today, gone tomorrow") suggested that large amounts of superannuation lump sums are being used to pay off debt at retirement.

As your consultation paper notes, the current group of 50 – 69 year olds are approaching retirement carrying higher levels of debt that previous generations.

These high levels of debt at retirement jeopardise the fundamental goal of superannuation policy, ie to enhance retirement incomes.

Financial deregulation and the resulting competition among lenders have increased the availability of consumer debt. This financial intermediation has increased consumers ability to effectively access their superannuation before retirement (by borrowing now and paying off the debt at retirement).

While superannuation legislation provides some discouragement for this practice (SIS legislation prevents superannuation being used by individuals as security for loans), the ability to access a lump sum at retirement (to pay off debt) certainly influences decisions about borrowing by both lenders and borrowers.

In order to achieve superannuation policy goals, however, it would be undesirable and unrealistic to curb financial intermediation or to curb lending to senior Australians.

We suggest, however, two policy changes in superannuation which may change individual behaviour to encourage lower levels of debt at retirement:

1. Upper limits on lump sum withdrawals

In section 4.1 we suggest a portion of superannuation benefits should be required to be taken as an income stream. If a large part of superannuation was required to be taken as an income stream at retirement (with upper limits on withdrawals), then consumers would not be able to use the bulk of their superannuation to pay off debt at retirement as a lump sum.

This would focus behaviour on using super for retirement income purposes and give consumers pause to think about taking on large debts approaching retirement.

2. Universal Benefit Projections for superannuation

The Institute notes it is Government policy to provide each member of a superannuation fund an annual projection of their likely benefits at retirement.

We believe that many individuals have an unrealistically high expectation of their level of benefits at retirement and that this high expectation may influence their decisions about the level of borrowing.

Having a realistic forecast of benefits at retirement may assist in providing consumers with more realistic expectations about superannuation benefits and may temper their appetite to have large outstanding debts closer to retirement.