Submission to the Henry Tax Review - Retirement Income System

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A phased approach to increasing age pension adequacy and improving personal saving for retirement

Background

In Australia as in many developed countries, demographic changes indicate the possibility of stress on pure age pension systems in future. This would arise from the combination of a higher ratio of retired to working age people, and/or an insufficient increase in productivity and production to make up the shortfall. Heading this off would involve more investment to increase productivity and production, and/or changes to migration and family policies to address the demographics directly (but these would also involve more investment for the needs of those demographic cohorts). These issues apply whether the needs of the retired are met through the age pension system or through superannuation, private savings and investments, or in any other way.

From the narrow perspective of age pensions alone, there is an obvious remedy: simply raise the age pension entitlement age, so that recipients form a smaller group and workers a larger one, so restoring a ratio that provides adequacy. However, this moves many problems to other policy areas and to the other pillars of the system. In particular, it does not address the investment issue or the need to maintain employment levels, both for the older workers and for the wider population. At the individual level, people coming up to retirement would face a major hurdle in planning and providing for retirement and/or continuing to work if they faced a large or abrupt increase in the entitlement age.

In the following material I outline recommendations to address these other problems, apart from employment levels, which I shall cover in another submission to the main part of the tax review.

Recommendations

For present purposes, I am assuming that there will be an increase in the entitlement age for age pensions. This is no great assumption, as it covers a wide range of possible increases and phasing in, including making no change. Exploring this range permitted comparison with present arrangements and led me to definite recommendations:-

(1.) Commencing as soon as practical, phase in an increase of the entitlement age, by 1 year for every 2 (say) calendar years that pass until the entitlement age reaches 70 (say). The precise numbers may vary, and the upper age need not be determined straight away. Age pensions for this smaller group should be increased to maintain adequacy for them as needed, based on CPI rather than wage levels but not means tested so as not to create adverse incentives for the other pillars. This strengthens the adequacy of the age pension pillar fast enough to head off problems in that pillar while providing time for the other recommendations to strengthen the other pillars, flowing through further saving in those to investment. This measure targets the age pension pillar.

(2.) Cut personal income tax in step with reductions in outgoings on the age pension system to allow individuals to save more through the other pillars, superannuation and voluntary saving. To encourage this, and to target the savings so that they flow through to investment of the sort that will support the lifestyles of people becoming more dependent on these pillars, implement much of these cuts by increasing superannuation income tax concessions, indexed to a proportion of the average wage. Ideally this could be as high as (say) 16% or approximately one sixth, but this is likely to be too high to be realistic in the near future because of the need for the tax base to fund other policy objectives outside the retirement area and because funding needs for age pensions will only fall gradually. Therefore this proportion should be increased from time to time as circumstances warrant, rather than determined and set up from the beginning of these reforms. This measure targets the superannuation pillar.

(3a.) **Target personal income tax cuts further, to people approaching retirement, by setting up a tax cut age matched actuarially to the entitlement age.** This age would fall in step with increases in the entitlement age, in such a way that younger people would be largely unaffected while older people would have a window allowing them to save for retirement more effectively. This is more equitable as so much of their financial planning for retirement has already taken place without being able to anticipate these reforms, yet it does not come at the expense of younger groups as these will also benefit from this window in their turn. As this window corresponds to a shorter time horizon until retirement, the older group falling within the window has a greater incentive for saving over current consumption. This measure targets the voluntary savings pillar.

(3b.) Alternatively, rather than target tax cuts by age, set up a distinct SAYE (Save As You Earn) fund somewhat like those found in Singapore and other countries and make compensating income tax cuts across the board. This reduces the complexity of the tax system itself by separating various things off – modularisation. This fund should have three main features: a progressive contribution structure (say, 10% of income above a threshold); a cap, savings above which could be drawn down (say, of the order of the $289,000 cited in note 2 of page 8 of the Retirement Incomes Consultation Paper, suitably indexed); and, a cap reset age actuarially matched to the age pension entitlement age as described above, when the cap would be reset to zero allowing people to draw down their savings (if they predeceased this age, their savings would be freed up for their estates at the date at which they would have reached that age). Additionally, it may be convenient to do any or all of the following: shift superannuation income tax concessions to this scheme, crediting these superannuation savings towards the cap, to assist the modularisation; rather than credit interest to individual accounts, waive fees and apply interest/usufruct to the age pension pillar or even to consolidated revenue generally (reducing the degree of hypothecation); and, integrate it with other funds like the Future Fund to the extent that this gives true synergies rather than a reduction in modularisation. This allows more flexibility, both in regard to existing political commitments to personal tax cuts which would not apply to the SAYE scheme, and in regard to how people could direct their income (as they would not be constrained once they reached the target set by the cap). This measure also targets the voluntary savings pillar.

Effects on the areas of equity, risk, myopia and institutional failure

Clearly recommendations (3a.) and (3b.) above address intergenerational equity that would otherwise be adversely affected by recommendation (1.), and all the recommendations address equity broadly.

The Retirement Incomes Consultation Paper describes the risks as political risk, investment risk, inflation risk and longevity risk (page 31 and elsewhere). Recommendation (3b.) addresses political risk by increasing transparency so that “raiding” would be visible, and by reducing incentives for raiding by making usufruct available to governments. Recommendation (1.) addresses investment risk at the upper end, by minimising longevity risk so that individuals do not face adverse incentives to over-invest. Recommendations (2.), (3a.) and (3b.) address the rest of investment risk, also providing suitable incentives and opportunities to avoid institutional failure. Inflation risk is addressed partly by the indexing explicitly present in the recommendations or implicit in their increases of individual discretion to allocate funds and in the shorter time horizons needing to be covered because of recommendation (1.), and partly by increasing the scope of governments to increase the adequacy of age pensions because recommendation (1.) reduces the size of the group needing them over time.

Between them, all the recommendations address myopia. However, a rational response to investment risk may be misunderstood as myopia; the value of savings and investments depends on future revenue streams, which may be uncertain. There is a little known feature of this variation, that *it may well grow exponentially even faster than the exponential growth of the savings and investments* (I have confirmed this for simple cases, using the repeated composition of Probability Generating Functions). This means that, no matter how much an investment portfolio is diversified, eventually any investment strategy collapses. In many cases, what appears to be myopia is in fact a sound approach to exponentially increasing uncertainty over longer time horizons, particularly for superannuation with fees and charges (we may be seeing some of the consequences of this now). The combination of recommendations above mitigates this difficulty as much as is practical, by providing a mixed approach. The very longest time horizons are covered by the age pension pillar, using the greatest possible diversification through the resources of the whole politico-economic system. Medium time horizons are covered by the superannuation pillar, with some diversification, and shorter time horizons are covered by the voluntary saving pillar.