COMMITTEE FOR SUSTAINABLE RETIREMENT INCOMES

Sustainable Retirement Incomes Position Paper

Prepared by CSRI for the National Reform Summit in consultation with the Leadership Group

7 August 2015

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1. Introduction

This paper has been developed by the Committee for Sustainable Retirement Incomes (CSRI) for the National Reform Summit both to provide background for informed discussion and to begin the critical process of developing a consensus about the need for reform and the direction of that reform. It has been prepared in consultation with the CSRI's Leadership Group comprising a broad cross section of business and community groups including Industry Super Australia, National Seniors Australia, Council of the Ageing (Australia), Australian Council of Social Service, Association of Independent Retirees and Academy of the Social Sciences of Australia. While not everything in the paper is agreed, there is agreement to the conclusion at the end of the paper.

Despite the strengths of Australia's retirement income system, there are deep challenges that have the potential to compromise its effectiveness and sustainability.

Constant piecemeal change and continued speculation around superannuation rules and age pension eligibility create great uncertainty for Australians in and near retirement. Member disengagement with the system provides the opportunity for the system to be politicised and this in turn undermines community support for the system.

Policy formulation that ignores broader implications and flow-on effects may result in unintended adverse consequences. Of particular relevance has been the tendency to consider public pension, taxation and superannuation regulatory reforms in separate domains, resulting in poor system integration, excessive complexity and often a failure to achieve their objectives because of countervailing effects in the other domains.

The Government's response to the Financial System Inquiry (FSI) Report, and the foreshadowed Tax White Paper, offer scope to address some of the issues, insofar as they cover the tax and superannuation system.

Despite the pressing need for reform, there is growing recognition that the development of good public policy is severely hampered by the absence of an overarching policy framework and the dominance of sectional interests. There is an urgent need for a systems-wide perspective in shaping retirement income policies.

The outline of the paper is as follows. Section 2 provides context for consideration of an appropriate set of objectives and principles that inform the assessment of the retirement income system and proposed reforms. Section 3 explores the weaknesses of the current system. Section 4 canvasses possible directions for reform. Section 5 sets out a conclusion that has been agreed by the CSRI's Leadership Group, including about the need for holistic reform and the general direction such reform should pursue.

2. Review of the Current System

2.1 Three Pillar Retirement System

In Australia, retirement incomes policy is essentially based on three pillars:

- The means tested and publicly funded age pension, and associated allowances and concessions;
- Compulsory private superannuation savings through the mandated superannuation guarantee arrangements, supported by tax concessions and with extensive associated regulations; and
- Voluntary private superannuation savings that are also supported by tax concessions and with extensive associated regulations.

A fourth pillar could be said to be owner-occupied housing as it is tax exempted, represents the largest personal asset for most Australians, reduces housing costs in old age and represents a potential source of retirement income. Private saving outside all of these is also a source of funding for retirement for many people. We will, however, use the conventional three-pillar approach as our framework here.

This three-pillar approach has considerable theoretical strengths:

> "*it provides a system intended to satisfy the minimum needs of all Australians, provides the capacity for individuals to enhance their retirement income, and spreads risks between the public and private sectors in a fiscally responsible way."* (Henry Review, *Australia's Future Tax System* 2009, p 14)

The Henry Review (2009, p 10) argued that the strengths of the existing three-pillar system should be preserved on the basis that:

> *"Not only does this system spread the responsibility and risk of providing retirement incomes in a fiscally sustainable way, it is also a structure that is likely to be durable and relevant across a broad range of economic, demographic and social outcomes. Retirement arrangements involve very long term planning horizons and there is considerable merit in avoiding inessential large changes."*

Despite the theoretical benefits of the system, it also has a number of limitations. These limitations, as discussed in Section 3, arise to some extent from the tendency to treat each pillar independently of others even though their interaction has a significant influence on outcomes.

2.2 Goals, Objectives and Instruments

In 2013, the government set up the Charter Group to develop and recommend a Charter of Superannuation Adequacy and Sustainability that would serve to guide future changes to the superannuation system consistent with the principles of certainty, adequacy, fairness and sustainability.

> *"During the consultation process, it became obvious that there is a range of views on what super is for. Some see its purpose as alleviating poverty (not a widely held view) while some see super more as wealth-building and even as building intergenerational wealth. The great bulk of opinion is somewhere in the middle; that is, that super is intended to provide more dignity in retirement, giving people a standard of living above the safety net afforded by the Age Pension."* (Super Charter Group 2013)

This Committee suspects there may also be some public confusion concerning the purpose and objective of the age pension system, notwithstanding its much longer history.

It is very hard to make and sustain good policy if the public is confused about the objectives of that policy. And in the case of the retirement income system there is an unfortunate lack of clearly articulated and authoritative goals and objectives. Furthermore, articulation of goals and measurable objectives for the whole retirement income system, including superannuation, which are then recognized by government, would assist in providing a framework to guide future policy development and ensure the coherence of the whole system is achieved and maintained. This development of retirement incomes policy goals and objectives should be cognizant of the rationale for government intervention, taking into account relevant market, personal and government failure arguments and sound public policy principles of efficiency and equity.

While there is no authoritative official framework of goals and objectives there does seem to be a reasonable degree of common ground among the experts. For example, the Retirement Income Consultation Paper (AFTS 2008) identifies five objectives for assessing a retirement income system, namely that it should be:

- broad and adequate, in that it protects those unable to save against poverty in their old age and provides the means by which individuals must or can save for their retirement;
- acceptable to individuals, in that it considers the income needs of individuals both before and after retirement, is equitable and does not bias inappropriately other saving decisions;
- robust, in that it deals appropriately with investment, inflation and longevity risk;
- simple and approachable, in that it allows individuals to make decisions which are in their best interests; and
- sustainable, in that it is financially sound and detracts as little as possible from economic growth.

Similarly, the Charter Group (2013) concluded that, at a high level, the objectives of the Australian superannuation system are to:

- provide an adequate level of retirement income;
- relieve pressure on the age pension; and
- increase national saving, creating a pool of patient capital to be invested as decided by fiduciary trustees.

The FSI Report (2014, p 95) suggested that the specific objective of the superannuation system is "to provide income in retirement to substitute or supplement the Age Pension". It further proposed a number of sub-objectives, namely to:

- facilitate consumption smoothing over the course of an individual's life;
- help people manage financial risks in retirement;
- be fully funded from savings;
- be invested in the best interests of superannuation fund members;
- alleviate fiscal pressures on government from the retirement income system; and
- be simple and efficient, and provide safeguards.

In the Committee's view the single basic goal of the retirement income system should be to ensure an adequate income in old age.

What constitutes such an "adequate" income varies according to circumstances. For those people who have not been able to provide for themselves in retirement an adequate income must be defined relative to community norms. The minimum objective for those people who need to access a social safety net should be to alleviate poverty in old age. For the majority of people, what constitutes an adequate income in retirement will normally be considered relative to both community standards and their past income while they were working (encompassing the spreading of lifetime incomes and consumption). A key issue to resolve is the extent to which income replacement, in addition to poverty alleviation, should be publicly supported.

The single goal of the retirement income system is constrained – and complemented - by other concerns, described as principles, including broadness and adequacy, fairness and acceptability, robustness, simplicity and certainty, and sustainability.

A significant point of contention is whether one of the goals of the superanuation system is to reduce the burden on the budget of the age pension. The current design of the system means that, for most people, superannuation entitlements are expected to be supplemented by some age pension. While this involves decreasing numbers receiving full rate pensions and an increasing proportion receiving part-rate pensions, some view the fact that the majority will remain eligible for some age pension as a failure of the system.

There is also contention about whether the superannuation system should facilitate the smoothing of incomes regardless of the level of income to achieve some level of income replacement. This might be achieved by exempting contributions and fund earnings from tax and subjecting all benefits to the standard personal income tax scale; a broadly similar effect might be achieved if contributions were taxed at the contributor's marginal tax rate less a standard percentage discount and benefits left tax free. Arguably, such an approach would not involve any real 'concession' because the lifetime incomes that are spread would remain subject to the progressive income tax scale. Some argue, however, that this would still involve favouring superannuation over other savings including owner-occupied housing, and involve allowing those on high incomes to access higher tax 'concessions' on their higher superannuation savings than those with low and middle incomes.According to this view, income smoothing should only be facilitated up to some specific level of savings or retirement income, not to some replacement rate. Whichever view is taken, there is agreement that public support for retirement incomes should not be used for other purposes and should not disproportionately benefit people on high incomes: the personal income tax's progressive scale should be applied in one way or another to superannuation savings.

2.3 Principles

The principles against which the performance of the system should be addressed are:

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

3. Weaknesses of the Current System

This section seeks to identify the weaknesses of the retirement incomes system against the principles of broadness and adequacy, fairness and equity, stability and certainty, and sustainability. An examination of each element of the superannuation system (accumulation and post retirement) and the pensions system on the basis of these principles demonstrates a number of problems with the status quo.

3.1 Safety Net

3.1.1 Adequacy of the age pension

While the level of the age pension is slightly below international measures of relative poverty, it has been increased substantially over the last two decades relative to earnings and is higher than the base pension in many developed countries. Increasing the age pension further would be costly as it would benefit many on middle incomes as well as those on low incomes given the phased withdrawal of benefits.

That said, some older Australians have incomes that leave them considerably below standard measures of relative poverty. Private renters receive significantly lower levels of assistance than those in public housing and face much higher housing costs than the majority of aged people who own their own homes and have limited, if any, mortgages to finance. The vast majority of pensioner couples are homeowners, while only one in two singles is a home owner.[1] The Henry Review (2009) noted that there is a strong case for aligning rental assistance and public housing subsidies.

'Allowance' payments for those below age pension age who are unable to find work are also well below the level of the pension and atre indexed only to the CPI. The current benchmark for indexing the age pension, on the other hand, is reasonably likely over time to increase the pension relative to community incomes in an ageing population. The Government's proposal in the 2014 Budget to replace the earnings-based pension indexation factor by the CPI would over time have significantly reduced the pension relative to community incomes. This proposal has since been withdrawn by the Government, as confirmed in the 2015 Budget, but there is a strong case for a common indexation factor across social security payments and for increased support for those unable to continue working through to age pension age.

So points of contention include:

- What is the appropriate indexation factor for the pension? Should the growth factor be consistent with other forms of government income support or should it (and the other payments) maintain relativity with broader community living standards?
- The respective priorities regarding the level of the base pension, rent assistance and other social security payments.

3.1.2 Problems with incentives to work and save

Another matter of potential concern is the impact of the targeting of the age pension through means testing arrangements on incentives to work and save, and possibly on the types of saving and assets held. While target efficiency is achieved by the withdrawal of pensions as pensioners' own-income and assets increase, inevitably this withdrawal gives rise to high effective marginal tax rates (EMTRs).

Chart 1 shows that single retirees face very high EMTRs where they earn between $10,000 and $50,000 in annual income, but that EMTRs are more moderate at higher income levels. On the whole, however, the evidence suggests that high effective marginal tax rates are not as significant a problem for age pensioners as for other classes of recipients of social security payments.

For the social security system as a whole, the highest EMTRs are typically experienced by households with dependent children, and most age pensioners do not have dependent children.[2] The picture for the aged is made more complicated by the different tax treatment of superannuation savings and earned income, such that EMTRs on superannuation income are generally around 50 per cent (though deeming and the asset test arrangements complicate this further) and between 60 and 65 per cent for earned income.

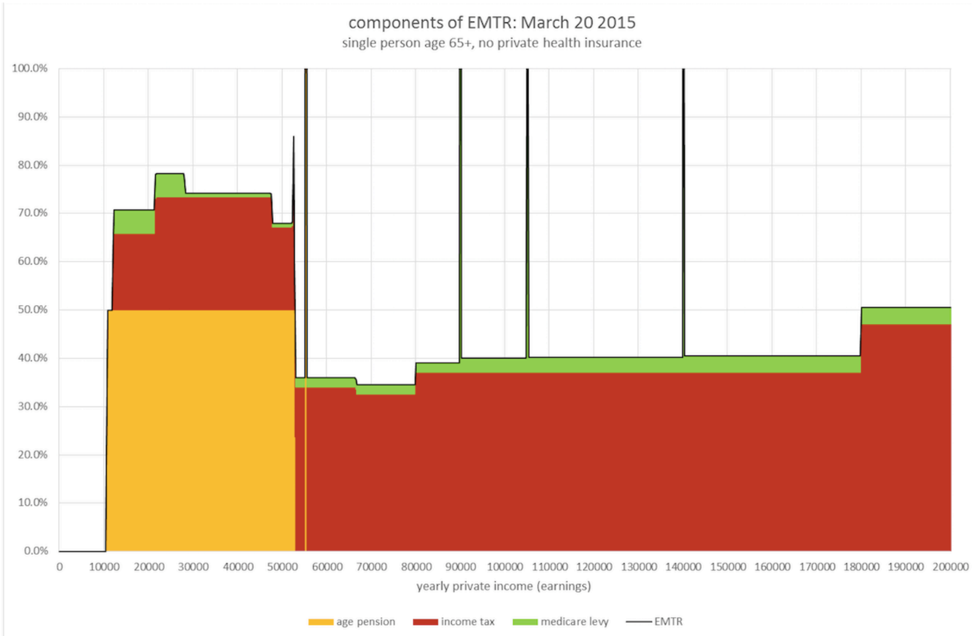
Anecdotally, disincentives to work and save may potentially be exacerbated by linking additional in-kind benefits (including through the seniors' pensioner health card) to pension eligibility. But usually

[1] 82.9 per cent of Age Pensioner couples and 53.4 per cent of singles are homeowners or purchasers" (DSS 2008, p 52).

[2] In 2002-03, 12.8% of households headed by a person aged 65-69 had dependent children (AMP/NATSEM 2004).

these supplementary benefits are not subject to separate means tests, and when they are, the EMTR phase-out range for these in-kind benefits is often quite narrow. For those pensioners potentially caught within this phase-out range there is an incentive to re-arrange their assets to avoid having an income in the relevant range by making fairly minor adjustments to their working hours.

Chart 1: Effective marginal tax rates



Source: Plunkett (2015).

The extent to which the level of effective marginal tax rates actually affects incentives to work and save is of course an empirical question. The limited evidence suggests that the most relevant factor determining the workforce participation of mature aged people is whether the individual is capable of working and whether suitable employment options are available.

This implies that if employment participation by age pensioners is to be lifted then it would be necessary to improve the skills and adaptive capacity of those workers with low education and qualifications and who have low participation even before they retire. Training effort would almost certainly be less costly and probably more effective than further attempts to lower effective tax rates for pensioners. Nonetheless, it is still important to be mindful of the potential distortionary effects of the high EMTRs on incentives to stay in the workforce for longer.

Potentially high effective tax rates for retirees may also act as a disincentive for people to save for their retirement. This is potentially relevant to people whose retirement income will ultimately place them somewhere along the phase-out range to qualify for a part pension. It would not make much difference to the saving behaviour of low-income people because their savings are mostly compulsory, nor to the twenty per cent of high income people who do not expect to be eligible for any government income support in their retirement.

The recently legislated tightening of the assets test involves a very high taper where assets lie between the new (higher) free areas and the new (lower) cut-out points. For each $1,000 of assets in these ranges the pension will be reduced by $78 a year, more than they could earn or might reasonably be expected to draw down in retirement. Critics argue that there are likely to be adverse incentive implications as a result for those approaching or in retirement with accumulated savings close to or within these ranges; others argue it will encourage people to draw down their assets over retirement.

Points of contention here include:

- The income test and assets test tapers;
- The income test deeming rates; and
- The relative priority between improving incentives to work and investing directly into employment capacity and opportunities.

3.1.3 Age Pension and Preservation Ages

With an ageing population and improving health and longevity of older people, there is a strong case for encouraging prolonged workforce participation by the aged. The current age of eligibility for the age pension does not reflect improvements in longevity that have occurred over time. Action has already been taken to increase the age pension age (already increased to 65 for women, and legislated to increase to 67 for men and women by 2024). The Government has proposed a further increase to age 70 by 2035.

Concern has been expressed, however, that, despite increasing life expectancy and health amongst the aged, employment capacity varies significantly according to skills, as has been mentioned above, and many low-income people do not presently have the skills that would enable them to compete for jobs or retrain into new and less physically intensive jobs in their later years.

Increasing the age pension age would affect a large proportion of people without contemporary skills and qualifications and those who are unable to continue working due to disability. Many would simply shift to, or continue to receive the disability support pension. In that event, changes to the age pension age may not achieve great savings. Others would only be eligible for the much lower Newstart Allowance and would be required to compete, probably in futile, against much younger jobseekers. This, together with the fact the measure would be likely to impact blue colour workers disproportionately (Gregory 2010), has significant equity implications.

In addition, some people (particularly women) contribute to society via non-paid work such as caring for the very old. This needs to be taken into account in the design of the retirement income system, and the balance between work and 'leisure' as living standards improve should be debated more widely before the age pension age is increased further.

A further consideration is that the age pension age is currently higher than the preservation age – the earliest age at which benefits may be taken from accumulated savings – allowing scope to dissipate retirement savings before reaching age pension age. The preservation age affects how well the system supports genuine retirement income and consumption. From 1 July 2015, the preservation age is 56 (rising to 60 in 2024) while the age pension age is 65 and will increase to 67. There is some risk of savings being taken via lump sums before age pension age, adding to reliance on the pension, though so far this has not presented a serious problem (PC 2015).

Points of contention include:

- Should the age pension age be firmly tied to life expectancy or to assessments of the capacity of the vast majority to continue paid employment?
- Should the preservation age be aligned with age pension age or set at some fixed number of years lower?

3.1.4 Improving the efficiency of the safety net

The cost of the age pension has increased in real terms by 35 per cent between 2007 -2008 and 2014-15, with between 70-80 per cent of people of retirement age receiving some form of pension (CIS 2015).

The exemption of the family home in the pension means test provides an important element of security in retirement but is inconsistent with targeting to those with the greatest need. Homeowners face lower housing costs, have a substantially higher net worth, and on average have more non-housing assets than those who don't own their own homes. They therefore have greater ability to support themselves than non-homeowners. The new pension assets test attempts to take this into account through the higher thresholds for non home-owners but, for those with few assets, pension entitlements are very similar for home owners and non home-owners. While the family home has been exempt from the means test almost since the age pension was introduced, the case for full exemption is becoming weaker as home assets and other assets are growing. Some argue that, as the superannuation system matures, there is a strong case to include the value of the home above some threshold. The impact on incomes and consumption could be ameliorated by allowing the age pension to continue to be paid and recovered later from the estate. Any such change could be phased in over time as the superannuation system matures, for example, so that no-one over the age of say 55 would need to alter their present retirement plans, and/or by setting a high threshold and reducing it over time.

The treatment of savings within the income test is dependent on the form of those savings. This in turn may result in people with similar wealth levels receiving different rates of pension. For example, assets held in bank accounts and share portfolios may reduce the rate of pension because they generate income whereas assets in holiday homes and art collections do not. The current dual income and assets tests can result in people with the same wealth receiving different rates of pension. While the asset test, in principle, treats all forms of savings equally, whether and how it is applied depends on the level and form of an individual's wealth.

Points of contention include:

- Whether the family home should continue to be fully exempt;
- The relationship between the income test and the assets test and whether the treatment of all assets should be the same.

3.2 Superannuation Contributions

The level of superannuation contributions required for adequate income in retirement, and the balance between mandated and voluntary contributions, depends on what is considered adequate for the majority of people.

In very broad terms, to achieve an income replacement rate of about 70 per cent that would approach a comfortable lifestyle for someone on average earnings, superannuation contribution levels would need to be around 12% over 30 years of employment (more for those on high incomes, and less for those who will remain eligible for substantial levels of age pension) (OECD 2013). It is noted that some of the contribution (typically about one percentage point) funds insurance premiums not retirement incomes; on the other hand, the average period of contributions is significantly more than 30 years.

When the Keating Government first implemented the Superannuation Guarantee, it proposed (but did not legislate for) steadily increasing the compulsory rate to 15 per cent, while much later the Henry Review (2009) suggested leaving the mandated contribution rate at 9 per cent and relying upon incentives for people to save more voluntarily (Parliamentary Library 2014, p 4).

For middle income earners and above, the mandated level of contribution is currently too low for many to maintain living standards in and through retirement. However, this is very often made up for by voluntary contributions (and other saving), or some people may also decide that they do not require replacement to that percentage level to live comfortably.

On the other hand, the current mandated level of contribution is sufficient for low income earners to maintain their (modest) living standards in retirement given their access to at least a part age pension. The compulsory contribution rate, by design, imposes a constraint on liquidity for some in this income cohort at times in their lives when they face other significant priorities (e.g. housing, education, training and child rearing).

The replacement rate outcomes arising from compulsory superannuation and voluntary saving are strongly linked to workforce participation. Work patterns vary markedly due to gender, skills, individual work preferences and opportunities, and migration. Groups with more varied work participation, such as women, tend to experience lower retirement incomes, presenting serious problems particularly for those who live on their own, who do not share a partner's superannuation and do not share expenses.

A flat compulsory contribution rate across all income cohorts and work patterns has limitations given that different groups vary in their capacity to save at different stages of their lifetimes. Increasing the mandated rate for compulsory superannuation would have a greater negative impact on low-income earners while those on higher incomes who want to maintain their higher living standards in retirement can do so by placing greater reliance on voluntary savings.

In cases where superannuation is not compulsory (i.e. for low wage earners and those over 70), such employees may not be receiving an equivalent increase is cash income in place of a superannuation contribution. The $450 per month threshold for SGC contributions has been in place since the SGC was introduced and has never been adjusted. Because an employer is relieved of a 9.5 per cent on-cost where pay is below the threshold, it acts as a cap on the earnings of part-time and casual workers. It also does not recognize that many part-time and casual employees work more than one job. This may mean that they are not eligible for SGC contributions at any of those jobs and at the same time do not receive the benefit of an equivalent amount in their pay.

Points of contention include:

- Whether the mandated employer contribution should continue to be increased as legislated to 12 per cent, left at around 10 per cent, or increased beyond 12 per cent;
- Whether the mandate should be extended to those earning less than $450 a month or to the self-employed;
- Whether people who are income-constrained should have access to part of their compulsory savings during their working lives.

3.3 Superannuation Taxation

There are strong theoretical arguments in favour of expenditure tax treatment of superannuation savings – involving exempting contributions and earnings from tax and applying full marginal tax rates to withdrawals at the benefit stage (referred to as 'EET'). This has merit in terms of facilitating the spreading of lifetime earnings and providing a motivation to continue working into retirement while retaining tax progressivity. It also has the budgetary advantage of timing revenue receipts to coincide with population ageing. However, Australia has now entrenched a very different approach – a variant of the comprehensive income tax (TTE) framework involving concessional tax rates on contributions and earnings during the accumulation phase, and no tax on benefits or on earnings in superannuation pension accounts (ttE).

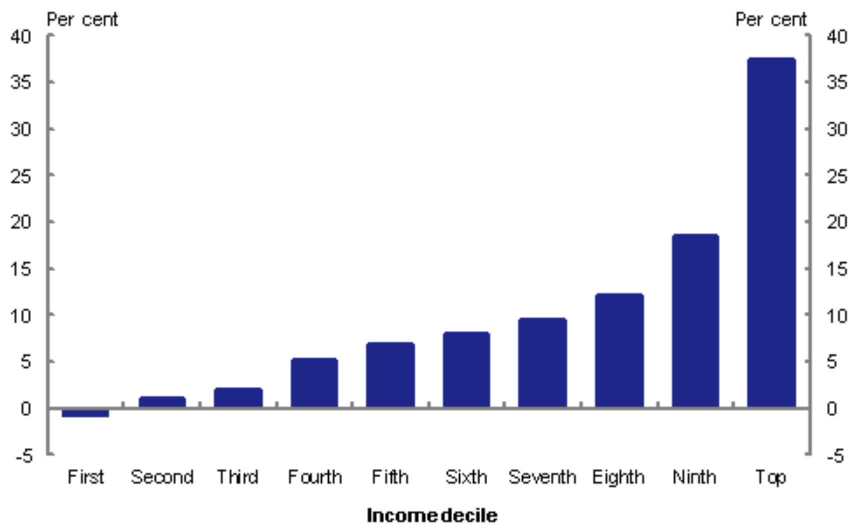
Measuring the tax expenditures involved is complex and depends fundamentally on the benchmark tax regime chosen. With a TTE benchmark (the way bank and most other non-home savings are taxed), Treasury estimates the cost of the concessions at currently around $30 billion a year. It is not known what the figure would be using an EET benchmark, but Treasury data suggest a TEE (or comprehensive consumption tax) benchmark would lead to a tax expenditure figure of around $11 billion.

Regardless of the benchmark used to measure the cost of superannuation concessions, the size of the concession provided (per dollar earned) is skewed to high income earners whose marginal income tax rate is substantially above the 15 per cent contributions tax (though this has been moderated in part by the 30 per cent rate applying to contributions by those earning more than $300,000 a year) and 15 per cent earnings tax during accumulation and zero earnings tax in retirement. The size of the tax benefit that the superannuation tax confers relative to the treatment of other earnings favours higher income earners with higher marginal tax rates and a greater capacity to undertake voluntary saving. During retirement, earnings on superannuation savings in pension accounts receive preferential tax treatment compared to other savings, as they are tax-free. This is likely to provide a greater concession to individuals with greater superannuation savings.

On the other hand, for low-income earners on the lowest tax rate who do not receive income support, the 15 per cent contributions and earnings tax provides little if any concession. For those below the tax threshold, there is a tax penalty.

Using a comprehensive income tax basis as the benchmark (which as noted above results in a higher estimate of the superannuation tax expenditure), Chart 3 shows that the majority of tax concessions accrue to the top 20 per cent of income earners. With other benchmarks the total tax expenditures would be lower but the distribution towards higher income groups would remain.

Chart 3: Share of total superannuation tax concessions by income decile



Source: Treasury, based on an analysis of 2011-12 Australian Taxation Office data.

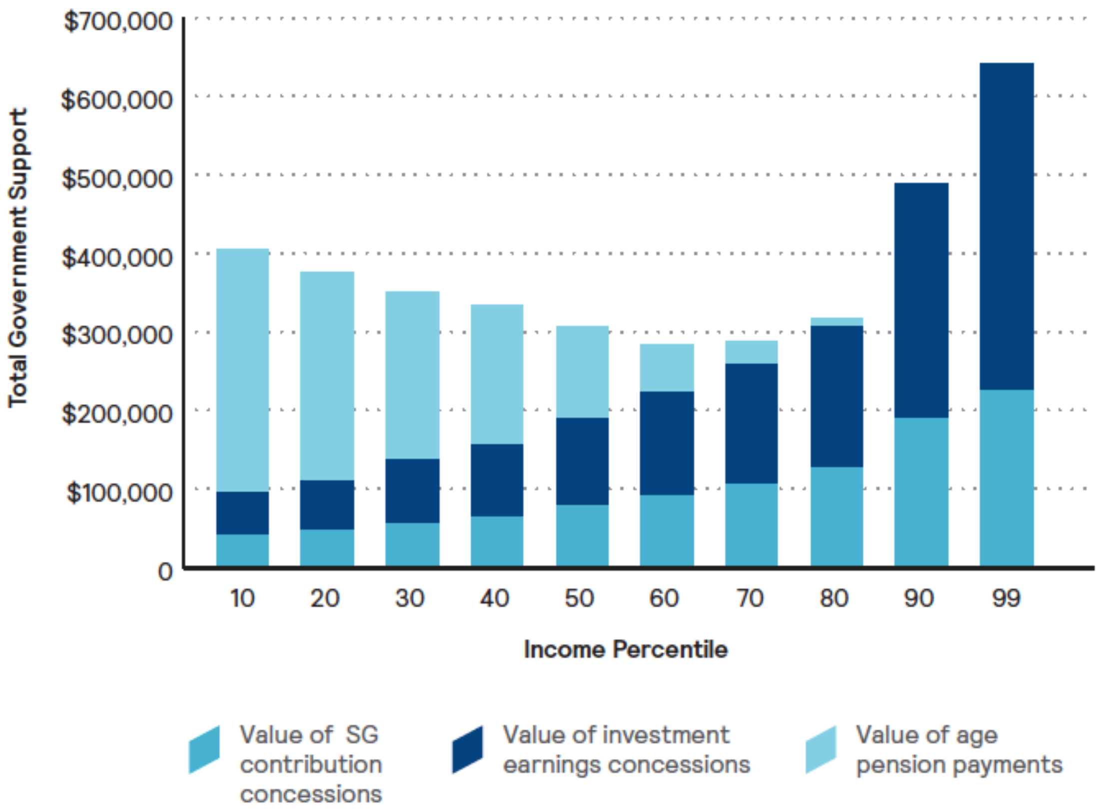
A more complete account of government support is provided by combining superannuation taxation concessions and the age pension. Clearly, if tax concessions were to be reduced or removed then the net superannuation benefits would also be reduced which may lead to lower superannuation savings and an increase in future age pension costs. Chart 4 from AIST/Mercer indicates the level of total support across a lifetime at 10 income levels (based broadly on the TTE tax benchmark). It shows that total income support from the government initially decreases as income rises; however at higher incomes, the total cost increases. While using a different methodology, Rice Warner demonstrate a similar skewing of support at high income levels (Rice Warner 2015).

The question this raises is where should the line be drawn when assessing the distributional consequences of retirement incomes policies. Is it a problem if individual components of government support (particularly superannuation tax concessions) are not particularly or at all progressive so long as government support overall is progressive? In general terms, it is our contention that the design of the retirement income system should be consistent with the articulation of the objective of maintaining adequate incomes. This in turn implies targeting the distribution of government assistance to those in greatest need.

Points of contention include:

- How best to measure the tax concessions applying to superannuation; and
- The most suitable option to contain the costs and to improve equity.

Chart 4: Combined superannuation tax concessions and pension payments by income decile



Source: AIST/Mercer 2015

3.4 Post retirement income arrangements

Superannuation generates concessionally taxed savings for retirement by mandating and encouraging contributions. If the objective of the superannuation system is to provide adequate retirement incomes, to the extent that superannuation is treated more favorably than other savings, a case can be made for providing restrictions to ensure that a substantial part of the accumulated funds are taken as income streams. If, however, the tax treatment of superannuation was little different to that of other forms of savings, there would be little need to ensure that the accumulated superannuation balances are used solely for retirement incomes purposes.

The current regulatory regime in the retirement phase is designed to ensure that the capital underpinning a retirement product is drawn down over time. The underlying purpose of these restrictions is to prevent the use of tax-advantaged retirement income to be used for wealth accumulation purposes rather than to facilitate the provision of retirement incomes (Treasury 2015).

The main ways superannuation savings are used to support retirement are phased withdrawal products and lump sum withdrawals used to pay off home mortgages. The proportions of estimated retirement benefits taken as income streams for 2013-14 are summarised in Table 1 according to both assets and the number of member accounts. 83 per cent of *assets* were rolled over to an account-based pension in this year, only 9 per cent was taken as a full lump sum and 7 per cent was taken as a partial lump sum. On the other hand, 34 per cent of *accounts* were taken as full lump sums, 25 per cent as partial lump sums and 41 per cent as account-based pensions, indicating those members taking full lump sums generally have low balances (and the proportion of people with these will fall as the superannuation system matures).

Table 1. Retirement rollovers and benefits payments – estimated split

	Assets		Accounts	
	($b)	(%)	('000)	(%)
Lump Sum				
Full Lump Sum	5.24	9.5	130	34.2
Partial Lump Sum	3.99	7.2	94	24.7
Subtotal Lump Sum	**9.23**	**16.7**	**224**	**58.9**
Pension				
Pension	**46.14**	**83.3**	**156**	**41.1**
Subtotal Pension	**46.14**	**83.3**	**156**	**41.1**
Total	**55.36**	**100.0**	**381**	**100.0**

Source: Derived from Rice Warner's analysis of a dataset comprising information from more than 10 million member records representing more than $55 billion in assets for 2013-14.

The data also shows that only 28 per cent of accounts with balances of $50,000 or less are taken as pension rollovers. However, for balances between $50,000 and $100,000, the split between accounts taken as lump sums and those taken as pensions is roughly even. Most notably, for balances of more than $300,000, almost 87 per cent of accounts are taken as allocated pensions (Rice Warner 2015). Similar results were provided by Rothman and Wang (2013) (Table 2). Of the people who opt for lump sums, Australian Bureau of Statistics data (2013) suggests one quarter invest in their own home, 18 per cent reinvest as ordinary money and 13 per cent reinvest into another retirement scheme (Rice Warner 2015).

Table 2: Retired persons, lump sum payments and superannuation income by gross weekly income (percentage of those with a superannuation benefit)

	Received or is receiving superannuation pension/superannuation annuity			**Received a lump sum only**	**Received a lump sum (with or without income steam)**
Gross weekly income	Has received a lump sum	Never received a lump sum	Received an annuity with or without lump sum		
$1-$299	19%	12%	32%	68%	88%
$300-$599	33%	38%	71%	29%	62%
$600-$999	42%	43%	85%	15%	57%
$1,000-$1,499	32%	57%	89%	11%	43%
$1,500-$1,999	27%	49%	76%	24%	51%
$2,000 or more	23%	66%	89%	10%	33%

Source: Rothman and Wang (2013, p 8).

Under current arrangements, the long-term risks related to inflation, investment and lifetime longevity are left to individuals to manage, with the publicly provided age pension acting as a minimum income guarantee. As people live longer, there is some risk that individuals will exhaust their assets before they die. So far, however, the greater problem seems to be that high levels of self-insurance result in retirees living overly frugally (FSI 2014; Wu, Asher, Meyricke and Thorpe, 2015) and leaving large superannuation savings to their estates.

Despite the growing prevalence of allocated pensions, hardly any assets are currently used to purchase products that include longevity insurance, and lifetime annuities are generally perceived within the industry and amongst retirees as poor investments given fiduciary requirements and the availability of the age pension for protection.

The issue has been raised as to whether changes are needed to the post retirement arrangements to ensure that longevity, inflation and investment risk are better managed by some form of risk pooling rather than each individual managing these risks on their own. In formulating policies for the post retirement phase, it needs to be recognized that timing of retirement can be a significant risk and the needs of individuals vary greatly at retirement.

How public policy should assist individuals to manage their different needs is unclear. On the one hand, it may be appropriate to ensure that retirement income products offer some flexibility in how retirees can access and invest their post retirement assets, though the flexibility may involve complex choices. On the other hand, a very simple and reasonably stable and reliable income stream for life might better enable individuals to, through consumption choices, manage their different needs. Such an approach would make retirement more akin to working life, where individuals pursue their interests through their consumption choices based on a reasonably stable and reliable income stream.

The amount received after retirement under account-based pensions and similar approaches may be quite variable depending upon the nature of the investments and the investment returns. Buying a long-term annuity, however, increases the risk of market timing at the time of retirement (Rice Warner 2011). While many members have little control over the timing of their retirement, they can adjust their investment strategies to prepare for the uncertainty of investment markets at the point of retirement.

Individuals can be in retirement for long periods of time and therefore the investment of their accumulated superannuation balances should include a growth component that seeks to achieve a return in excess of inflation and a liquid component that provides access to capital. This helps to explain why such a large proportion of retirees opt for retirement products that allow drawdown from a mix of cash, dividend-based investments and longer-term growth pools, particularly when investment markets are strong, and do not favour lifetime annuities or other products that require low risk investments only.

Points of contention include:

- The extent to which people should be pressed to take their benefits in the form of income streams;
- Whether this should include pressure to insure against longevity risk; and
- Whether further government intervention is needed to help the market manage longevity risk and to offer attractive products to retirees.

4. Options for reform

Reform of the retirement income system is needed to better address the following factors:

- Misalignment – to ensure the individual components of the system and their interactions are aligned with the overarching objectives of the system.

- Complexity – the system has been subjected to frequent changes resulting in high system complexity so the opportunity should be taken to identify solutions that reduce, rather than add, to overall system complexity.
- Widely varying personal circumstances – the current arrangements inhibit the ability of people with interrupted work patterns to save sufficiently for their retirement: measures to address such variations in circumstances and preferences should be considered.

The following section canvasses for discussion a range of reform options that might be considered as part of a comprehensive review of the system. Several represent alternatives and no attempt has been made at this stage to consider the possible trade-offs; for example between tighter targeting and more individual flexibility and less complexity. In addition, many of the options would need considerable work to refine and implement and a number would require lengthy phasing in arrangements. The options should not be considered in isolation but rather would need to be considered as possible elements of a coherent and comprehensive reform package for the retirement income system. Section 5 of this paper presents in conclusion the basis for such a reform package and the general direction that might be pursued given the trade-offs that need to be made.

4.1 Safety Net

Options to improve the efficiency and adequacy of the safety net include:

1. Replacing the current earnings related indexation factor with a combination of an automatic indexation by the CPI (the most common form of indexation in the developed world) and a regular (say biennial or three-yearly) independent review of relativities with community income movements, this revised approach to apply consistently to all social security pensions and allowances.
2. Increasing the rate of rental assistance for those in private rental accommodation.

Options to tighten the means testing include:

3. Reviewing the deeming rates for superannuation savings on the assumption that the capital should be drawn down over lifetimes (and not proceeding with the legislated changes to the assets test).
4. Improving the targeting of the age pension to those with the greatest need by including the deemed value of owner-occupied housing (beyond some threshold) in the means test while deferring the impact on the age pension by treating it as a contingent liability against the estate. This could be phased in over time as the superannuation system matures.
5. Unlocking an income stream from home equity by legislating for a default ‘reverse mortgage’ product although the complexities associated with this option need to be recognized.

Employment participation by older people could be further encouraged by:

6. Improving access to career counselling and support for older workers and introducing employment-training programs targeted at improving the skills and adaptive capacity of those workers with low education and qualifications and who have low participation even before they retire.
7. Strengthening protections against age discrimination in employment.
8. Incentivizing people to work longer through easing the means test on earned income by relaxing the withdrawal rate on earned income (e.g. going back to the 40% introduced with the GST). The implications for distributional fairness would need to be investigated.

This could also be enhanced by increasing the age pension and preservation ages. It is important to recognize there is no ‘perfect’ age pension age as there will always be people who need help and can’t work under the age (whatever is chosen) although as a services–based economy, over time more workers will be able to work longer. Options for consideration include:

9. Raising the superannuation preservation age to equal the pension age or fixing the gap between the two at (say) 5 years.
10. Removing the pension and preservation ages from the political arena by linking them to trend growth in longevity but only after the impact of the currently legislated pension age increases have been fully assessed.

11. Applying some level of tax on any superannuation benefits in excess of some threshold taken before age pension age. The setting of a threshold would help to overcome equity issues for low income earners who would need to call on such access.
12. Introducing a new Transition to Retirement payment, equal to the pension, limited to people above preservation age who have been on Newstart for more than, say, three years.

4.2 Superannuation

In setting the mandated contribution level, needs in terms of retirement incomes must be balanced with needs at other stages of lifecycle. Allowing flexibility for people to set their contribution levels below the mandated amount in specified personal circumstances, perhaps subject to them subsequently making up the difference in their contribution rate, is one option but it would raise significant administration hurdles and would increase the system's complexity.

For people with interrupted careers, another option is to increase the annual contribution caps. This would make it easier for people with interrupted careers to make up for nil contributions in earlier years with higher contributions in later years. On the other hand, only a minority of people can afford to contribute at or above the annual caps, and people with low or modest lifetime earnings (including a majority of women) would benefit more from reducing the tax on contributions.
Another option is to apply lifetime caps. While this would enhance flexibility for some, it would constrain income smoothing at high income levels and may be difficult to administer.

Possible options for consideration here include:

13. Broadening the coverage of the mandated contribution, by reducing or removing the $450 per month threshold and extending the mandate to self-employed people.
14. Containing future increases in the mandated employer contribution to 10 per cent or 12 per cent.
15. Increasing the current annual caps or replacing them with lifetime caps (eg $2.5 million or some multiple of final earnings).

4.3 Superannuation tax

Regarding retirement income taxation, there are strong theoretical arguments in favour of expenditure tax treatment – involving exempting contributions and earnings from tax and applying full marginal tax rates at the benefit withdrawal stage (referred to as EET). However, Australia has now entrenched a very different approach, a comprehensive income tax (ttE) involving concessional tax on contributions and earnings (at all stages) and no tax on benefits as they are withdrawn.

Switching from ttE to EET or tEt would require complex transitional arrangements over 40 years or more if existing superannuation savings from previously taxed contributions and earnings were to be exempt, and would probably have severe transitional implications for government revenue.

Alternative incremental changes might be considered which promote the spreading of lifetime incomes to support genuine retirement income purposes and close off opportunities for higher income earners to gain inappropriately from the tax concessions.

A related issue is whether those on low incomes, including those with intermittent employment, should have access to some co-contribution through the tax system. The Henry Review approach would provide some such assistance via the 'negative tax' on contributions when incomes are low. Another option is to require contributions to be made from parental leave payments. The means-tested age pension of course provides an important safety net, and those with employed partners can share their partners' superannuation savings.

Possible approaches to superannuation tax include the following:

16. The Henry Review proposals involving applying a progressive tax on contributions based on individuals' marginal tax rates less a rebate of 20 per cent (including or excluding a negative tax at low incomes), and equalizing the earnings tax rate between the accumulation and post-retirement phases by applying a standard 7.5 per cent tax on fund earnings in both the accumulation and post-retirement phases.

17. Applying the 30 per cent tax on contributions from incomes above $180,000 rather than $300,000, removing the tax where income is below $37,000 (where the marginal rate of income tax is 19 per cent or lower) and applying a tax on fund earnings in the post-retirement phase. (This would broadly apply the Henry Report approach to the current tax scale.)
18. Reducing the non-concessional contribution caps to say equal the concessional contribution cap levels.

As mentioned above, there are also various options for capping contributions.

Access to superannuation savings could be limited through adopting changes to the preservation age. Options include:

19. Increasing the preservation age to 62, retaining the five-year gap with the age pension age.
20. Aligning the preservation age and the age pension age.
21. Limiting the amount of superannuation that can be taken as a lump sum, particularly before age pension age.
22. Exempting people unable to engage in paid work due to disability or caring roles from an increase in the preservation age, and taking into account much lower life expectancy amongst Aboriginal and Torres Strait Islander peoples.

4.4 Post retirement system

In making recommendations relating to the post retirement phase, the FSI Panel considered and rejected both a mandate and a default post retirement solution because it considered these would not allow sufficient flexibility given variations in people's circumstances. Its recommendation of a Comprehensive Income Product for Retirement (CIPR) offers the potential to achieve some of the core benefits of mandate and defaults without imposing a one-size-fits-all solution.

The benefits that the CIPR shares with both default and mandatory annuitization include:

- Helping to address the challenge that many retirees face in transitioning to the retirement phase of superannuation. Retirees are currently highly reliant on affiliated financial advisers in navigating post retirement choices. The quality of such advice has been demonstrated to vary significantly.
- Enabling trustees to provide a form of guidance in making sound retirement decisions, rather than leaving it to the individual member to be solely responsible.

A design strength of CIPR is that it is not necessarily one but a combination of income products. Research has shown that full annuitization of super savings is not an optimal drawdown strategy for an individual given current financial rules (Hanewald, Piggott and Sherris 2013) as retirement can last for several decades, and exposure to market risk is necessary to ensure that inflation does not erode savings. Certain product types, such as variable annuities with equity exposures and insurers' guarantees, have had limited success in other markets because they are often difficult to price and the hedging of risks is difficult. Options such as keeping market risk with the individual via an account based pension combined with a deferred annuity product to cover longevity risk, as discussed in Bateman et al. (2001) may be catered for within a CIPR.

A CIPR provides greater flexibility than a default – the investment is not made until the retiree has approved it. As such, it reduces the risk of retirees being placed automatically into products that are unsuitable for their needs.

On the other hand, the fact that a CIPR is "modular" and optional could invite a lot of options and choices that may be difficult for consumers to understand.

While the concept of the CIPR has some merit, its ability to deliver improved retirement outcomes will depend largely on how it is implemented and received. Unless widely adopted by retirees, the products could still suffer from adverse selection and fiduciary requirements that add to costs, and many people may choose for good reason to continue to rely heavily on the age pension for longevity insurance. Potential CIPRs should be assessed according to a number of criteria including:

- Their ability to trade off the various risks (investment, inflation, longevity) that retirees will face through retirement.

- Their ability to spread consumption between working life and over retirement years in a way that is tailored to the different phases of retirement. For example, individuals in early retirement tend rightly to be more concerned with balancing growth and liquidity, while in later retirement longevity risk becomes prominent.
- The extent to which individuals do indeed take up the products.

Depending on the success of CIPRs in these terms, consideration might also need to be given to options to improve the capacity of the market to manage longevity risk including through 'longevity bonds'.

It may also be worth considering whether an approach that better integrates the accumulation phase and the retirement phase could be made to deliver superior outcomes. Is it possible to achieve a true retirement income system, where people join on a whole-of-life basis so as to receive an income stream in retirement, which would be similar to a defined benefits plan but the employer would not carry the liability? Achievement of this objective may involve some form of collective defined contribution plan linked directly to targeted levels of retirement incomes with regular advice to members about the contribution levels required to achieve the intended retirement income.

The main options therefore are:

1. The FSI recommendation that funds must offer members access to a CIPR.
2. Developing CIPRs as a default option.
3. Mandating some form of CIPR (ie requiring retirees to direct some of their savings into an annuity product that covers longevity risk).
4. Improving the capacity of the market to offer attractive CIPRs by introducing longevity bonds that allow the market to trade efficiently risks relating to longevity.

5. Conclusion

Despite the strengths of Australia's retirement income system, there are deep challenges that have the potential to compromise its effectiveness and sustainability. Significant issues raised in previous inquiries that have not yet been addressed include:

- The absence of a clear overarching objective for the retirement income system that can support a consistent set of policies across the different parts of the system.
- The associated inefficiency, complexity and frequency of changes in the system that undermines public confidence.
- The lack of fairness, particularly the excessive tax concessions for those on high incomes.
- The gender bias in superannuation outcomes.
- The increasing cost of the system to government, particularly because tax concessions are not efficiently targeted at meeting the system's objectives.
- The superannuation framework requires individuals to confront a complex set of financial decisions at and after retirement, without providing the same degree of support as it does during the accumulation phase.

Constant piecemeal change and continued speculation around superannuation rules and age pension eligibility create great uncertainty for Australians in and planning for retirement. Member disengagement with the system provides the opportunity for the system to be politicised which in turn undermines community support for the system. So long as the faults remain, any informed observer is likely to expect further change irrespective of calls for a pause. Accordingly if we want to improve confidence in the system we need to improve it.

With the Commonwealth budget coming under increasing pressure, the fiscal sustainability of the retirement income system demands greater scrutiny.

Goals and principles

Our starting point is clarity of purpose - the single basic goal of the retirement income system should be to ensure an adequate income in old age. Consistent with this basic goal, reforms should address the following principles:

- Broadness and adequacy, incorporating both an adequate income guarantee to protect people from poverty in old age and adequate income maintenance at and through retirement;
- Fairness and acceptability, where assistance is targeted and incentives to work and save are retained;
- Robustness, with risks allocated in a way that government and individuals can reasonably manage, balancing flexibility and stability;
- Simplicity and certainty, so people can plan their retirement and manage their savings with confidence; and
- Sustainability, including both financial sustainability for government and continuing community support for the system.

Reform direction

Further reform of the Australian retirement incomes system is now important and should be pursued in the following way:

- a holistic approach is essential rather than the piecemeal changes that have marked the political debate to date;
- reform must focus on ensuring the system delivers adequate and secure incomes in old age;
- reform should encompass changes in both superannuation tax arrangements and age pension arrangements to improve fairness and sustainability;
- reform should encourage self-reliance and support the ability of older Australians to remain in the workforce while recognising not all are able to do so and many contribute through unpaid activities;
- reform should improve the effectiveness of the superannuation system in delivering adequate and secure incomes throughout retirement; and
- reform must be phased in gradually, allowing people to plan their retirement with confidence and taking into account that it will still be some time before most older Australians fully benefit from the superannuation system.

There will need to be constructive discussion of the inevitable trade-offs involved in reform if it is to be financially sustainable in delivering adequate retirement incomes. A reform package might be along the following lines:

Safety net and other social policy

- Giving priority in improving the safety net to those with unavoidably high housing costs and those below age pension age who are unable to continue working.
- Better targeting social security payments in a way that retains incentives to work and save and does not distort the manner in which assets are held or used. Supporting the ability of older Australians to remain in the workforce while recognizing some are unable to continue to do so while others contribute substantially to society through unpaid work.
- Facilitating transition to retirement while encouraging people to maintain sufficient savings for their retirement incomes.

Superannuation

- Setting the level of mandated contributions so that, together with the tax concessions, any age pension entitlement and any government contributions, they deliver adequate retirement incomes for Australians while not imposing an excessive burden when they face other cost of living pressures.
- The cost burden on government should by minimised by containing tax concessions to levels consistent with the objective of the superannuation system in a way that preserves the integrity and progressivity of the personal income tax system.
- Allowing flexibility in the way people use their superannuation savings while ensuring they are used for genuine retirement income purposes.
- Balancing flexibility with sufficient structure to ensure that risks – including market and longevity risks – are being managed in such a way that enhances people's retirement incomes and living standards.

A gradual approach to implementation should be pursued to minimise any disruption to existing retirement plans.

The resulting system would be more coherent and consistent with the overarching objective. It would also address the principles mentioned above by:

- Improving poverty alleviation for older Australians below age pension age and those with unavoidably high housing costs;
- Improving the adequacy of retirement incomes;
- Improving fairness by a more coherent means test and by introducing progressivity in the superannuation tax arrangements;
- Improving the security of retirement incomes by better addressing risks including market and longevity risks; and
- Improved sustainability by better targeting benefits and concessions, reducing reliance on the age pension, promoting greater workforce participation, encouraging self-reliance, and lifting retirement incomes delivered by superannuation.