COMMITTEE FOR SUSTAINABLE RETIREMENT INCOMES

Encouraging Sustainability and Self-Provision in Retirement Incomes

Policy Conclusions

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Contents

Executive Summary [1]

The retirement income system must deliver *adequate* levels of retirement income, but equally the funding of that system must be *sustainable*. Sustainable for the individual and sustainable for the nation.

That sustainability partly depends upon the incentives for self-provision and the extent of the (mandatory) requirements on each individual to self-provide by saving for their retirement. These self-provided savings also mean that that retirement income should be drawn from each retiree's accumulated capital plus any other sources of the retiree's income.

There is a potential tension between the cost of incentives for the individual to encourage more self-provision and the net cost to the Budget. On the other hand, taxes or means tests which act as a disincentive to self-provision, should not be so high that their net impact on self-provision also comes at a net cost to the Budget. The aim therefore is to strike the right balance between the impact of incentives and disincentives on self-provision and their overall fiscal impact.

Whether or not the retirement income system will be sustainable in the future is a matter of judgement. One view is that the ageing of the population will create unsustainable financial pressures as the cost of the retirement income system is projected on present policies to increase relative to GDP. There is also likely to be additional financial pressure because future generations may not have the same access to housing assets, and may instead require more superannuation savings to maintain an equivalent living standard. According to this view, unless policy is changed, the cost of the system will not only out-pace GDP but will impose unfair burdens on future generations, each new generation paying more to support the previous one's retirement than that generation paid for its predecessor. Fundamentally it is a matter of priorities, and governments and households are always shifting their expenditure patterns according to changing demands and associated priorities.

The position taken here is that, given the likely pressure on the Budget for additional retirement income expenditures, it is especially beholden on policy makers to ensure the cost-effectiveness of all retirement income expenditures, including the tax expenditures.

In what follows this position paper considers:

- The impact of the marginal tax rates resulting from the interaction of the pension means test and the income tax system on incentives to continue working and to save for retirement;
- The appropriate level of superannuation concessions to encourage self-provision through superannuation saving and/or to compensate people for not being able to access their savings prior to retirement, and the overall fairness and equity of the system;
- Changes to the pensions means test to make it fairer.

The conclusions from this discussion are summarised below.

[1] This paper draws heavily on roundtables of experts organised by the CSRI and hosted by the Academy of Social Sciences in Australia, and on the papers prepared for those roundtables. Other people who have been consulted, apart from members of the CSRI itself, are Phil Gallagher, Mike Woods, Ian Yates, Nick Mersiades, and David Cox. It should be emphasised, however, that this is a draft position paper by the CSRI which takes full responsibility for its content and views.

Self-provision and Effective Marginal Tax Rates

The interaction of the taxation and pension systems means that for those receiving an age pension and superannuation, the effective marginal tax rates (EMTRs) can in some instances be quite high and potentially act as such a disincentive. The available evidence, however, suggests that in practice these high EMTRs are not having a significant impact on work behaviour or on saving.

Policy changes to reduce the rate of taper in the pension income test or to increase the generosity of the superannuation tax concessions are likely to cost the Budget a lot more revenue than any additional revenue raised from an increase in employment or saving.

The conclusion therefore is that there is no need to change the pension income test nor the taxation of superannuation on account of the impact on incentives. Mandated superannuation contributions should, however, remain an integral part of the superannuation system, although the level and timing of any further increase is subject to further consideration on adequacy grounds (see Adequacy position paper). Some adjustments should, however, be made to the pension assets test (see further below).

Superannuation taxation concessions

Past assessments of superannuation tax concessions, including both the impact of compulsory superannuation contributions and the earnings thereon have demonstrated that the bulk of the concessions have benefitted high income earners. In particular, high income earners have made very large 'voluntary' contributions in addition to their mandatory contributions, and applying the tax concessions to these voluntary contributions and the earnings there-on has strongly increased their share of the total benefit.

As discussed in the paper, there is therefore a strong case for limiting the amount of contributions that would attract a concessional tax rate, by either:

- Removing or reducing the concessions by changing the tts in a ttE scheme
    - Probably use the Henry approach of using the marginal rate less x%

- Keeping the present tax rate scale with caps
    - Reduce threshold to $180,000 from announced $250,000 threshold for higher 30% tax rate, and
    - Support the caps most recently announced by the Government, which would:
        - Impose a limit of $1.6 million that can be transferred into the tax free retirement phase;
        - Reduce the threshold at which high income earners pay additional contributions tax from $300,000 to $250,000;
        - Reduce the annual cap on concessional before-tax superannuation contributions to $25,000 (currently $30,000 under age 50 and $35,000 for ages 50 and over); and
        - Lower the annual non-concessional contributions cap to $100,000, and limit the availability of these non-concessional contributions to individuals with a superannuation balance of no more than $1.6 million.

- These new revised caps will only affect a very small number of high-income individuals, and will still allow the vast majority of people to maintain a legitimate level of concessional saving consistent with meeting reasonable adequacy targets for their retirement incomes.

Superannuation savings represent a deliberate government policy that requires people to spread their income and consumption over their adult lifetimes. Thus these savings only benefit the superannuant and increase their taxable capacity when they can be accessed and are withdrawn. One of the main benefits of an EET regime is that the timing of revenue collections coincides with when the tax payer is in retirement. It therefore helps to offset the negative revenue impact of a higher dependency ratio on the budget. Accordingly, while changing to an expenditure tax (EET) regime for superannuation is no longer practical, an EET regime is a relevant benchmark for evaluating current tax concessions for mandatory superannuation contributions.

The modelling results presented in the paper suggest that viewed against an EET benchmark, the tax concessions allowed under recently announced Government policy (as outlined above) and the earnings thereon would not be particularly concessional or unfair in their distribution. A modest level of concessions would be consistent with people not being able to access their superannuation savings before attaining the prescribed superannuation preservation age.

Means test

The general consensus among the experts at the recent CSRI Roundtable was that while the income testing arrangements for the age pension work reasonably well and should not be substantially changed, the asset testing arrangements can be improved. The main changes to the assets test further considered in this paper are:

- changes to how the assets test is working for assets above the current threshold of $298,500;
- whether housing should remain outside the means test; and
- changes in the assets test treatment of funds that become available when pensioners attempt to access the equity that they have in their home from the sale of the home in favour of 'right sizing', or by accessing an equity related product such as a reverse mortgage.

Assets test

The new assets test to come into effect from January 2017 effectively has too high a taper, discriminates against annuities, and is likely to encourage behaviour aimed at avoidance. Alternative options discussed in the paper would be to:

- merge the income and assets tests by deeming income from assets that would include some return of capital, or
- retain a separate assets test but reduce the rate of taper to say $1.75 per fortnight reduction for each extra $1000 of assets

The merged means test would strongly encourage retirees to draw down their assets, encouraging in particular CIPRs and annuities. The improvements in self-provision would also lead to some long-term offsetting savings.

<u>Housing and the pension means test</u>

The value of the home is no different from any other asset, and in principle it should be included in the pension means test. The difficulty however is how to access pensioners' home equity without reducing their cash income, especially as some pensioners own high value homes but are income poor.

The starting presumption in this position paper is that any proposal to include housing assets in the means test will be accompanied by action to enable the pensioner to tap the equity in their home (see also the position paper on Adequacy).

In order to effectively tap this home equity, the exemption limit below which home equity would not be subject to the means test would need to be set reasonably high; thus reducing the available savings that could be made on the age pension.

Two criteria are proposed to help set the exemption limit for home equity in the means test. So to ensure that no pensioner suffers a loss of cash income, the exemption limit should be set sufficiently high to:

- allow the pensioner to raise sufficient revenue from some form of equity release product or arrangement that they can compensate their future income for the loss of pension income, and
- still have sufficient housing equity that is unencumbered to meet the requirements for accessing residential aged care as a non-supported resident in the future, if that became necessary.

Some may consider that a further problem with including the value of home equity in the pension means test is that there are large geographical variations in home values across Australia. What is being proposed, however, means that where pensioners have higher value homes, then they have more home equity to draw down on, and vice versa for people with low value homes. So it is hard to see how the former are being disadvantaged when it is only because they have more home equity to draw down on and the means to be more self-supporting.

A final critical consideration is how much advance notice should be given if it were decided to include the value of home equity in the pension means test. As a basis for discussion, it is suggested that no existing age pensioner should be affected by a change to include housing in the pension means test, and nor should any person who becomes eligible in the next 7 years be affected. In addition, the exemption cap should be phased in by gradually lowering it after the first year of introduction, reaching its final level in say 10 or 15 years, with a lower exemption level taking longer to phase in.

<u>Assets test treatment of funds released by accessing home equity</u>

With or without the inclusion of home equity in the pension means test there is a need to improve the incentives for pensioners to access this equity and improve their cash incomes.

Also it would be unfair and counter-productive to include any funds released in this way in the pension means test.

Accordingly, it is proposed to exempt the income from accessing home equity from the pensions income test up to some capped amount, providing this income was derived from a loan (as now) or an approved equity release product (ERP). Similarly, in the case of right-sizing the proceeds could be exempt from the means test up to some capped amount provided it was invested in an approved retirement income product. Furthermore, for the same reasons the means test for accessing aged care should be based on the remaining home equity after deducting the amounts that are encumbered by an ERP or an Aged Care Refundable Accommodation Deposit.

It is not considered that this change would involve much, if any, cost to the Budget.

Introduction

The purpose of the retirement income system is the sustainable provision of an adequate income in retirement. The level of funding for retirement incomes will be what is necessary to meet this purpose, and does not comprehend funding the accumulation of wealth and provision of bequests.

Clearly this level of funding must be sustainable – sustainable for the individual and sustainable for the nation. That sustainability in turn depends upon the incentives for self-provision and the extent of the requirements on each individual to self-provide for their retirement. The more that an individual self-provides, the less call there will be on the nation for funding retirement. At the same time, it is recognised that higher income people are typically better placed to self-provide than lower income people, so transfers are inevitably involved.

The level of self-provision for the majority of the population, who are not wholly reliant on the age pension, will need to be consistent with maintaining an adequate living standard in retirement through a combination of mandated and voluntary contributions.

- Mandated contributions should remain an integral part of the system, although the level and timing of any further increase is subject to further consideration on adequacy grounds (see Adequacy position paper).
- The extent of any concessions, if any, that might be needed to achieve a desired rate of self-provision, or to compensate savers for not having access to their superannuation savings prior to reaching retirement age, is discussed further below.

Self-provision also means that retirement income should be drawn from each retiree's accumulated capital plus any other sources of the retiree's income.

- Consequently, taxation of retirement incomes and any means tests should be based on both the capital and income from that capital.
- Similarly, in principle, all capital should be included in the means test, including the value of the home. How the value of the home might be included in the means test is a major issue to be discussed further below.

When assessing the sustainability of the retirement income system it is important to recognise the potential tension between providing incentives to the individual to encourage more self-provision and the possibility that those incentives nevertheless involve a net cost to the Budget. On the other hand, taxes or means tests which act as a disincentive to self-provision, should not be so high that their net impact on self-provision also comes at a net cost to the Budget. The aim therefore is to strike the right balance between the impact of incentives and disincentives on self-provision and their overall fiscal impact.

This requirement means that any assessment of the sustainability of the retirement income system should consider the system as a whole in an integrated way. At present, the current arrangements governing the interaction between the tax and social security system in relation to retirement income combine apparently concessional tax treatment of superannuation with moderately harsh age pension means testing. Accordingly, this paper starts with a discussion of how the interaction of the means test with the taxation system might affect the incentives for self-provision both prior to and after reaching retirement. In what follows after that discussion, however, it is more convenient to separate the discussion of first taxation issues and then the issues relating to the pensions means test.

Self-provision and Effective Marginal Tax Rates

The interaction of the taxation and pension systems means that for those receiving a part-age pension and who have substantial non-pension income (including from superannuation), the effective marginal tax rates (EMTRs) can be quite high on receipt of an extra dollar of employment income – between 70 and 80%. However, the Senior Australians and Pensioners Tax Offset provides a higher tax threshold for taxpayers of Age Pension age, so that a single age pensioner can earn income of as much as $32,279 before paying tax, and each member of a married couple can earn $28,974. By comparison the median private income for households aged 60 plus is just a few thousand dollars and the mean income is about $30,000 annually (PC 2015b:59), so most age pensioners would be subject to a low EMTR on an extra half day's work – most less than 20% and almost all less than 30%[2].

The potentially high EMTRs, for some age pensioners and quite a lot of other pensioners, raises the question of whether they act as a disincentive to keep working or to work part-time which would improve their income, reduce their immediate rate of drawdown on their superannuation and reduce the fiscal cost of the pension system. Equally, there is the possibility that high tax rates may deter savings for retirement, although under Australia's mandatory superannuation guarantee system this deterrence would really only affect voluntary savings, which are almost entirely the preserve of people earning very high incomes[3].

There was almost complete consensus among the experts at the recent CSRI Roundtable that the available behavioural evidence indicates that these tax rates have very little impact on decisions to keep working or saving. Some participants provided evidence suggesting that in terms of workforce impacts, the optimal pension withdrawal rate would in fact be higher than 50 per cent, as fewer people would then be subject to a means test, and it was argued that higher pension withdrawal rates would be more equitable than other recently proposed changes to the age pension to improve sustainability[4].

A quick summary of the evidence that the present pension means test is not having much impact on workforce participation includes:

- Modelling evidence indicates very low elasticities in the labour supply response to lower taxation by mature aged workers, and that other factors have much more influence on decisions by the elderly to keep working or not. Australia's aged employment participation rates compare well with other like countries, except New Zealand, but it is likely that other factors than EMTRs explain most or all of the difference with New Zealand.

- Most pensioners do not have the necessary capabilities to keep working, and most workers who can expect to eventually access the age pension have neither the income nor the need to save more prior to retirement. Thus, 55 per cent of the people who

[2] However, a single person receiving the disability pension who took a part-time job earning $16,000 annually would lose 37% in tax if they had no other non-pension income PC, 2015b:91).
[3] More than half the voluntary savings in 2012-13 were made by people with taxable incomes of $180,001 or more (Grattan Institute, 2015:42)
[4] Kudrna, G., 2016:2

access the age pension on reaching pension age, are transferring from another government income support payment (communication from DSS).

- 70% of all retirements occur before the age of 65 and just under half of all Australians who retire between the ages of 45 and 70 did so involuntarily (Productivity Commission 2015b:211).

- Mature aged people with necessary skills/qualifications do keep working. Mature aged participation rates are rising, probably because of the cohort effects of increasing education levels.
    - Improving skill levels through education and training, and retraining would have more impact on workforce participation, and would cost much less than action to reduce EMTRs.

The evidence regarding the impact of taxation on savings is that any concessions very largely affect the type of saving rather than the total amount:

- Savings are influenced by many factors, including the aim of achieving a target level of savings consistent with maintaining living standards in retirement. In other words, the income effect of a change in taxation typically outweighs the substitution effect on savings behaviour (Daley et al.,2015:20).

- It is the compulsory nature of the superannuation contributions in Australia, which has driven the overall increase in savings that can be attributed to superannuation since the introduction of the superannuation guarantee (Gruen & Soding, 2011).

- Very high income people are making substantial voluntary contributions to their superannuation accounts because of the tax advantages compared to other savings vehicles.

It has been argued, however, that even if the compulsory nature of superannuation contributions means that no tax concession is necessary to encourage saving, nevertheless the tax concession is a fair recompense for forcing people to save in this way whereby their savings are locked up until they attain the designated retirement age (Mercer, 2015:13, ACOSS, 2015:9).

At the moment, the superannuation tax concessions are believed to be very expensive, their cost (as currently measured) is certainly continuing to rise rapidly, and the evidence strongly suggests that the present superannuation tax concessions are encouraging tax minimisation strategies by wealthy people, at a considerable cost to the revenue. There is also a widespread belief that the present concessional tax treatment of superannuation is very unfair, and that, along with their rising cost, makes the present form of these concessions difficult to sustain financially. In response, the Government has recently proposed changes to the superannuation concessions to reduce their generosity to high income earners and to limit the amounts that can be claimed. As yet Parliament has still to agree on these proposed changes, and it is also not clear whether the proposed changes represent the best available. Accordingly, the system of concessional deductions is further considered below.

The Taxation of Superannuation

The purpose of superannuation is to facilitate the smoothing of incomes over time so that people enjoy an income in retirement that would allow them to broadly maintain their previous consumption standards. Thus superannuation tax should do no more and no less than facilitate the spreading of life-time incomes, and should only be used for this purpose. That requirement further means that the logical time to tax superannuation would be as superannuation balances are actually accessed and drawn down. This is consistent with the income smoothing function of superannuation, and it is only when the retiree accesses their income that they actually benefit from it. It also means that the timing of revenue collections would coincide with when the tax payer is in retirement. It therefore helps to offset the negative revenue impact of a higher dependency ratio on the budget.

Furthermore, in the Australian superannuation system the beneficiary cannot actually access their superannuation savings until they reach preservation age. Indeed, this is why taxing retirement incomes as they are accessed is what applies in most other countries. In addition, taxation on drawdown is what happens with a defined benefits superannuation pension in Australia, and it would be consistent with the timing of the social security pension means test. It is also what applies with capital gains taxation which are only taxed when they are realised and not when they accrue.

This implies that an appropriate benchmark against which superannuation taxation may be judged is an EET scheme, where the first E represents no taxation on contributions, the second E represents no taxation on fund earnings, and T represents full taxation at the time of withdrawal. Such an EET tax regime would, however, be more generous than applies to some other savings (where both contributions and the earnings on those savings are subject to full taxation). While there is no one indisputable basis for taxing superannuation, the following arguments have been used to justify this difference in the taxation of compulsory superannuation: first because of the mandatory nature of the superannuation guarantee scheme, second because of the particular purpose of superannuation discussed above, and third because superannuation provides no benefit nor taxable capacity before it is accessed.

That said, EET is only justified as a benchmark if the savings are genuinely for retirement consumption and not for wealth accumulation. If we actually had an EET regime then any withdrawals for whatever purpose would be fully taxed, and that would prevent the EET system providing much if any tax relief on any large sum for a bequest. But while the tax regime for superannuation continues to be based on a ttE regime, then consistent with the purpose of an EET benchmark separate action should be taken to limit withdrawals for the purpose of bequests.

In Australia's case reversion to taxing superannuation withdrawals would be very difficult – the grandfathering arrangements would likely result in a substantial loss of revenue for around twenty years. Given Australia ttE system for taxing superannuation - where the two tt's reflect *apparently* concessional tax rates on contributions and fund earnings respectively - these two tt's would best be set so as to mirror as closely as possible the results that would have been obtained if it had been possible to use an EET taxation regime.

The taxation issues that therefore need to be considered are:

- How concessional is the present taxation of superannuation relative to the EET benchmark?

- What are the distribution impacts of any such concessions, and what changes should be made to tax rates or caps on contributions to make the system more equitable?

- Whether the present concessions are sustainable or whether one or both of the tt's and/or the caps should be adjusted?

<u>How concessional is the present taxation of superannuation</u>

The Treasury Statement of Tax Expenditures shows that the annual cost of the present concessions is almost $30 billion and rising, and that 37 per cent of the total value of these concessions flows to the income earners in the top decile. This estimate of the value and distribution of the superannuation concessions, however, reflects a comparison with a comprehensive income tax regime (TTE) and an EET regime.

The Treasury comparison is based on superannuation balances as they stand at this point of time, including past accumulations that would no longer be possible. It is useful, when deciding future superannuation policy, to compare the cost of the present superannuation system, based on the present rules and regulations with the taxation revenue generated in the future using an EET benchmark. This comparison involves a projection ahead over the full lifetime of someone entering the workforce at age 18.

Modelling the tax that would be paid using an EET benchmark also requires a decision to be made as to what would represent an appropriate rate of drawdown by retirees on their superannuation balances. In fact, the modelling results for the amount of tax paid under an EET regime are quite sensitive to this rate of drawdown. The modelling results presented here for an EET tax regime attempt to replicate the taxes that would be paid when the mandatory SG superannuation system is mature. The modelling assumes a drawdown rate of 9% of the superannuation account balance at the end of the previous year. So the nominal amount withdrawn declines if the withdrawal rate is higher than the earnings rate of the fund. Arguably a more realistic drawdown schedule would allow for maintaining the drawdown amount in real terms, but even in that case many retirees want to spend more early in their retirement, and less later on when they are less active. Furthermore, any decline over time in a retiree's real superannuation income would be significantly offset for most retirees by an increase in their age pension entitlement.

Broadly speaking this 9 per cent drawdown rate used in the present modelling would allow median income retirees to achieve close to an adequate income through the remainder of their lives, being broadly similar to them devoting around 25 per cent of the initial balance to purchase a deferred annuity to give protection against longevity risk, and drawing down the remainder of the balance before the annuity takes effect. The modelling suggests that a male median income retiree would need to draw on a modest amount of other savings, in addition to their mandatory superannuation, to achieve an adequate retirement income (see Position Paper No. 1 on Adequacy). Alternatively, more superannuation could be drawn down prior to accessing a lower level deferred annuity. It is not considered, however, that such possible adjustments to achieve an adequate income would materially alter the conclusions that are reached below.

The results from modelling this preferred EET comparison are reported in the associated paper by Phil Gallagher from Industry Super Australia[5]. Gallagher has estimated the tax paid over their lifetimes by men and women with different incomes on their projected superannuation under the present ttE tax regime and under the benchmark EET tax regime. The modelling is consistent with the Government Superannuation Policy as announced on 16 September 2016.

In brief these results (Table 1) suggest that under the new rules recently announced by the Government, superannuation contributions and the earnings thereon will generally not be taxed concessionally relative to an EET benchmark. Indeed, these results suggest that for most income deciles there will be a tendency to over-tax superannuation relative to the preferred EET benchmark. Although if the conversion back into present values is done using indices of consumer prices instead of wage rates then any apparent over-taxation is mostly modest and for the most part fairly even across income deciles as a proportion of their taxation.

Importantly these results are sensitive to

- the rate of superannuation drawdown assumed in setting the EET benchmark, and
- the amount of voluntary saving through superannuation that is allowed.

If the EET benchmark had incorporated a higher 12 per cent rate of superannuation drawdown in retirement then under the Government's new policy, superannuation would then be shown as being concessionally taxed when measured against that EET benchmark, but only marginally so. This is because in that case, larger amounts would have been withdrawn in the early years of retirement and the EET average tax rates would also have been higher. Thus if the retiree relies a bit more on voluntary savings or has a higher rate of drawdown than modelled here, that would increase the tax paid under the EET benchmark. Nevertheless, any such adjustment would not materially alter the conclusion that most people do not experience significant tax concessions when the tax they are paying on their superannuation is measured against an Expenditure Benchmark. Most importantly, the modelling also suggests that if the action the Government has announced is not taken to limit voluntary contributions to superannuation then superannuation will continue to be taxed concessionally even when measured against an EET benchmark.

[5] This paper also provides a more detailed explanation of the modelling methodology.

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Table 1

Summary of ttE vs EET taxation for Quantiles of Actual Contributions and 9% Retirement Drawdown before Age 90

		WAGE DEFLATED				CPI DEFLATED			
Quantile	**Gender**	ttE PV Accumulation Taxes	EET PV Retirement Taxes	Accum/Ret %	Accum over or Under Taxed	ttE PV Accumulation Taxes	EET PV Retirement Taxes	Accum/Ret %	Accum over or Under Taxed
Decile 1	Female	$5,418	$22,667	24%	Under	$14,868	$42,631	35%	Under
	Male	$4,250	$6,836	62%	Under	$15,064	$12,493	121%	Over
Decile 2	Female	$17,351	$16,907	103%	Over	$38,732	$31,463	123%	Over
	Male	$23,894	$21,291	112%	Over	$54,852	$39,949	137%	Over
Decile 3	Female	$10,367	$24,472	42%	Under	$38,732	$46,161	84%	Under
	Male	$24,256	$26,697	91%	Under	$54,852	$50,531	109%	Over
Decile 4	Female	$14,771	$29,626	50%	Under	$53,698	$56,304	95%	Under
	Male	$42,783	$32,083	133%	Over	$70,934	$61,162	116%	Over
Decile 5	Female	$38,445	$33,269	116%	Over	$65,268	$63,508	103%	Over
	Male	$56,130	$34,734	162%	Over	$84,387	$66,419	127%	Over
Decile 6	Female	$47,289	$37,713	125%	Over	$78,393	$72,359	108%	Over
	Male	$69,331	$40,376	172%	Over	$100,829	$77,586	130%	Over
Decile 7	Female	$62,004	$36,983	168%	Over	$90,171	$70,899	127%	Over
	Male	$83,296	$34,734	240%	Over	$121,512	$66,419	183%	Over
Decile 8	Female	$76,814	$51,853	148%	Over	$111,793	$99,659	112%	Over
	Male	$116,224	$82,001	142%	Over	$172,839	$156,681	110%	Over
Decile 9	Female	$96,780	$81,571	119%	Over	$141,745	$155,869	91%	Under
	Male	$172,808	$113,721	152%	Over	$255,025	$216,710	118%	Over
Percentiles 90-95	Female	$146,101	$122,945	119%	Over	$217,616	$234,190	93%	Under
	Male	$214,902	$161,515	133%	Over	$311,261	$307,296	101%	Over
Percentiles 95-99	Female	$212,481	$190,211	112%	Over	$310,450	$361,732	86%	Under
	Male	$253,414	$198,767	127%	Over	$361,517	$378,011	96%	Under
Top 1%	Female	$265,206	$267,605	99%	Under	$383,619	$509,371	75%	Under
	Male	$289,654	$251,252	115%	Over	$408,489	$478,086	85%	Under

Source: See associated paper by Phil Gallagher of ISA.

These results may initially be somewhat surprising, given how different they are from the Treasury estimates of the revenue cost of (supposed) superannuation concessions and their distribution, using the TTE taxation regime as the basis for the comparison. The main reasons for this apparent difference in the distribution of the superannuation tax concessions seem to be:

- One benchmark (TTE) is highly progressive, based on marginal tax rates while wages are being earned, while the other (EET) is closer to a proportional tax based on (lower) average incomes with almost no tax threshold given the age pension. Accordingly, against the first benchmark a ttE tax regime appears to be highly concessional and highly regressive, while against the second benchmark this tax regime appears far less concessional (if at all) and not clearly regressive, so long as voluntary superannuation contributions are reined in.

- Inclusion of the age pension in the taxation estimated for low income retirees under the EET regime, increases their taxable income and consequently their tax rate under an EET regime relative to the rate they presently pay under the ttE regime. By contrast for high income earners, their tax rate on their retirement income drawdowns under an EET regime is projected to be less than they would pay under the ttE regime.

- This comparison is not comparing like with like. As described above, the TTE estimate of the tax concession is based on the distribution of present superannuation balances, whereas the EET projection reflects the distribution of balances into the future when the present superannuation guarantee scheme reaches its full maturity.

- In particular, the EET projection is limited to projecting accumulations that would be allowed under the Government's Superannuation Policy as announced on 16 September. Thus this projection does not include any large concessional and/or non-concessional contributions that have been allowed in the past. These large voluntary contributions have enormously favoured high income earners and help account for their much larger superannuation balances, and consequently their tax concessions being much higher when compared with a TTE benchmark.

- In addition, to the extent that high income earners have other non-superannuation income in their retirement, their average tax rates will be higher under an EET regime than modelled here, and accordingly the concessions on their superannuation income will have been underestimated in Table 1 above. Lower income people are much less likely to have large amounts of non-superannuation income in their retirement.

The conclusion from this modelling it that it is unlikely that superannuation would be highly concessionally taxed for most people relative to the preferred EET benchmark if the amount of superannuation contributions over and above those mandated by the Superannuation Guarantee are limited.

Thus this conclusion still leaves open the important issue of what action should be taken to limit contributions and the tax rate that should apply to very high income earners, noting that these people are the most likely to have already accumulated balances considerably larger than would be possible under the SG contribution rates.

Tax rate on high income earner's contributions

The Government and the Opposition both proposed in the last election campaign that the threshold for the top tax rate of 30% on contributions should start from $250,000[6]. It is suggested that instead the threshold for this higher tax rate could start at $180,000 to bring it more into line with the income tax rate scale. While there is a slim chance that such a lowering of the threshold for the 30% tax rate might result in over-taxing the superannuation balances of some high income earners against the EET benchmark, that would only be possible in the unlikely event that they had no other income in retirement than from their superannuation contributions.

Caps on large contributions

As already foreshadowed the single most important change that has been proposed to improve the equity and sustainability of the superannuation tax concessions is to tighten the caps limiting the size of these contributions.

The Grattan Institute for example has proposed a simple solution that would limit concessional superannuation contributions made from pre-tax income to just $11,000 per

[6] Labor has since suggested that this threshold might be reduced to $200,000

year. In addition, the Grattan Institute proposes a cap of $250,000 on non-concessional contributions made over a life-time. Both limits might well be judged as being too stringent, with the proposed limit on concessional contributions translating into a contribution rate of 9 per cent for someone earning 1.5 times average weekly ordinary time earnings (AWOTE). Instead, it would be possible to introduce an annual limit of say, $18,000 on concessional contributions which would translate into a contribution rate of 15 per cent for someone earning 1.5 times AWOTE. Such a cap would recognise the need for higher income earners to have a higher contribution rate if they are to maintain an adequate income in retirement; partly because they are not eligible for any income from the age pension.

But probably more realistically, the government has announced the following caps:

- capping the amount that can be transferred from a superannuation fund into the tax-free retirement phase at $1.6m;
- an annual limit of $25,000 on concessional contributions (currently $30,000 under age 50 and $35,000 for ages 50 and over);
- Lower the annual non-concessional contributions cap to $100,000, and these non-concessional contributions will also only be available to individuals with a superannuation balance of no more than $1.6 million.

The $1.6 million cap on the size of a retirement fund is an appropriate response to the need to target the level of concessions. This cap is in fact not a cap on superannuation savings as such, but on the amount of those savings that will be tax free. This cap only affects the taxation of people over 60 and who are retired, and it is estimated that at present only 123,400 people will therefore be affected (ISA, 2016: Table 5), and only 60,000 over the age of 60, all of whom are in the wealthiest 10 per cent of people aged over 60 (Daley, et al, 2016:16). Furthermore, this change is not draconian. The Government has estimated that a balance of $1.6 million can support an income stream in retirement of around four times the level of the single Age Pension. Also the earnings on any funds in the account in excess of $1.6 million would still only be taxed at a concessional rate of 15 per cent, so there would be no incentive for many people to switch funds out of superannuation.

An alternative cap when a superannuation account is in the pension-paying stage, which would serve the same purpose, would be to cap the income earnt on superannuation savings (at say $75,000), instead of the amount of superannuation savings that would be tax free ($1.6 million). The two different types of caps deliver much the same outcomes, but an earnings cap would probably handle financial volatility a little better and would also be a little simpler to administer.

The annual limit of $25,000 on concessional contributions is equivalent to allowing a maximum contribution rate of 12.6% of earnings for males earning 2.5 times AWOTE, and a maximum contribution rate of 15.2 per cent for equivalent females. These contribution rates are still consistent with allowing most people to provide adequately for their retirement. It will, however, be important that this $25,000 annual cap is indexed in future with wage rates.

Non-concessional contributions of as much as $100,000 in a single year is equivalent to allowing a 15 per cent contribution rate on an annual salary of as much as $666,667. The total amount of such voluntary contributions is of course also constrained by the cap of $1.6 million on the total amount of superannuation balances that can remain tax free in retirement. Nevertheless, this level of voluntary contributions should be sufficient to allow even very high income people to maintain their living standard in retirement purely by drawing down on their superannuation balances. So while this change should be supported there remains the question whether it sufficiently restricts the concessional tax treatment of superannuation, noting that the present excesses mainly arise out of the high rates of voluntary contributions by very high income people.

In that respect, it is arguable that the Government's original proposal of a cap of $500,000 on the amount of non-concessional contributions would have been better. Much of the opposition to this original proposal was on the alleged grounds that it would be retrospective. This opposition was not, however, correct. That proposal did not affect the taxation of past earnings in superannuation accounts. It would have only affected the taxation of future earnings, and the government has always been able to vary the taxation applying to any source of income going forward[7]. The reality is that very few people would ever have been affected by this $500,000 cap as it was larger than all but 5 per cent of the total amount in present superannuation balances. While on the other hand, a limit of $500,000 for men earning 2.5 times AWOTE over 45 years translates into an addition to their contribution rate of another 5.6%, and another 6.8% for the equivalent females[8]. The size of this addition to high income earners' superannuation savings would have represented sufficient additional voluntary superannuation saving to enable them to provide adequately for their retirement, and does not seem unreasonable.

There are, however, a number of other questions that arise in response to any cap on non-concessional contributions. First, will the cap on non-concessional contributions represent an undesirable limitation on the opportunities for people with broken careers or small business people to adequately save for their retirement? The ATO data show, however, that 95 per cent of the people who have made non-concessional contributions since 2007 have low account balances and are unlikely to be affected by either of the caps that have been considered. In addition, the majority of small businesses have special arrangements so they are allowed to contribute up to around $1.4 million into superannuation[9]. In short, it seems unlikely that the recently announced annual cap of $100,000 will act as limitation on small businesses and people with broken careers making provision for their genuine retirement needs.

Second, under the present tax arrangements, non-concessional superannuation contributions have proven to be an extremely attractive form of tax minimisation. Accordingly, it might be asked whether this new annual $100,000 cap will be sufficient to reduce this channel for tax avoidance which is unrelated to the true purpose of superannuation. Of course the number of annual $100,000 voluntary non-concessional contributions is also limited by the $1.6 million cap on the total superannuation balance that can be tax-free in retirement, but any balances in excess of that $1.6 million cap will still be taxed at what would be a concessional rate for most of the people affected.

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[7] For example, if the marginal tax rates were varied so that the earnings from non-superannuation savings were subject to a higher tax rate, no-one would be claiming retrospectivity. Nor is this decision affecting past non-concessional superannuation contributions any different from a decision to say reduce the fuel excise rebate which would affect the value of past purchases of mining shares.

[8] This is an under-estimate of the percentage increase in the contribution rate as a percentage of salary, as it is unlikely that someone earning 2.5 times AWOTE during most of their career, would earn that much for *all* 45 years of their career.

[9] More specifically small businesses are allowed to contribute up to around $1.4 million into superannuation if they qualify for either the small business 15 year CGT exemption or the $500,000 CGT retirement exemption.

Third, in this context consideration might be given to changing the present concessional contribution caps so that they are based on a maximum cap for *lifetime* contributions rather than a maximum *annual* contribution. This would help people with disrupted work patterns to save enough for an adequate retirement income. It should also be relatively straight forward administratively as it is believed the ATO has access to the necessary data. At the very least therefore the ATO should provide annual notices to taxpayers updating them on their entitlements to make additional contributions.

In fact, the recent Budget goes some way towards enabling people with disrupted work patterns to make catch-up contributions. The Budget proposes that taxpayers with a superannuation balance of less than $500,000 will be able to draw on unused pre-tax caps from the previous five years to make these catch-up contributions. In fact, the vast majority of people with disrupted work patterns, and especially women, would find it difficult financially to make a catch-up contribution of as much as $25,000 for each of the following five years when they are still raising their children[10]. Consequently, there is still a case for considering alternative ways of allowing them to "catch-up" later in their working careers when they are better able to increase their saving rates.

Finally, there are a few other issues that need to be considered to improve equity and sustainability. First the tax on contributions by low-income earners who would not normally pay tax should be rebated to their superannuation account, as the Government now proposes. Second, a number of measures could be considered to ensure that superannuation is only used for retirement income purposes and to prevent the present leakages of taxation, such as:

- Limiting offsets for dividend imputation to the level of earnings tax actually paid
- Remove limited recourse borrowing from superannuation funds
- Re-introducing a maximum withdrawal from allocated pensions to limit pre-death withdrawals in lieu of bequests.
- Introducing a tax of 15 per cent on any remaining funds in a superannuation account at the time of death so as to encourage retirees to use their superannuation to maintain their retirement income and not use superannuation as a tax sheltered form of bequests.

[10] Of those people with superannuation balances less than $500,000 who contributed more than $25,000 a year to superannuation, only 10 per cent are women below the age of 50 (Daley, et. al., 2016:12).

Pension Means Test

Assets test

There is wide agreement that people's assets, as well as their income, should be taken into account in the age pension means test. This is particularly the case for superannuation assets that are expected to provide retirement incomes, including by running down the capital over retirement years, and that are not meant to be used for wealth accumulation.

The current means test involves separate income and assets tests, and people are eligible for the lower level of age pension determined by the two tests. The tests are broadly aligned through thresholds (or free areas) that are roughly equivalent and having tapers above the thresholds that allow increases in total retirement incomes as private incomes or assets increase above the thresholds. The current income test taper is 50 percent (ie the pension is reduced by 50 cents for each dollar of private income above the threshold) and the current assets test taper involves reducing the pension by $1.50 per fortnight ($39 a year) for each additional $1,000 of assets.

There is considerable concern that the new assets test to come into force from 2017 has much too high a taper. The new taper is $3 per fortnight ($78 a year) for each $1,000 of assets above the threshold (new higher thresholds are also to come into effect). For a couple owning their own home, this new taper will apply to assets above $375,000 until the pension is fully withdrawn when assets reach around $825,000 (the exact figure will depend on the rate of pension at the time). Table 2 below illustrates the effect of the new taper on a home owning couple with assets at the threshold and the cut-out point on the couple's total income, if the couple chose to buy an indexed annuity with their assets or a CIPR involving a deferred annuity and an allocated pension. In both cases, the couple would be drawing down their assets over their retirement years and not using any of the assets for wealth accumulation, and would also be using their assets to insure against longevity in line with CSRI's views on the objectives of the retirement income system: the indexed annuity would be around 5% of the asset value and the CIPR would provide an income stream of around 9% of the assets.

The couple choosing an annuity would be considerably worse off having an extra $450,000 of assets, and the couple choosing a CIPR would be only $10,000 better off. That is, unless the couple chose to run down their assets without providing any longevity insurance, they would at best have only $10,000 more income despite saving an additional $450,000.

This does not appear to be consistent with the underlying purpose of the retirement incomes system and seems unfair, particularly given the compulsion to save for retirement. It is also likely to lead to distorted behaviour by people at or near retirement. Shifting assets into the home (by paying off mortgages, buying higher value homes, undertaking renovations) will allow people to fully retain their wealth with a marginal if any reduction in their incomes. Gifting money to children within the limits allowed by Centrelink will similarly allow them to retain almost all their income while directing super savings to wealth accumulation which is precisely what policy should be constraining. Those nearing retirement who might otherwise be encouraged to increase their super savings will be advised not to do so if their accumulated savings are approaching $375,000 or are unlikely to greatly exceed $825,000.

Table 2

Impact of new Assets Test on Incomes of Home-owning Couple with different levels of Assets

Assessed Assets $	Drawdown via indexed annuity (at 5%)[11]			Drawdown via CIPR (at 9% after purchase of a deferred annuity)[12]		
	Age pension $pa	Super income $pa	Total $pa	Age pension $pa	Super income $pa	Total $pa
375,000	34,252	18,750	53,002	34,252	33,750	68,002
825,000	Nil	41,250	41,250	Nil	78,250	78,250

Two options could be pursued to avoid these problems and provide a coherent approach to the means test:

- Merge the income and assets tests by deeming income from assets that includes some return of capital (say, 9% above $100,000 or $200,000), and adding this to any other income and then apply the existing income test. This is similar to the approach proposed in the Henry Report though that proposal did not include return of capital; it is also similar in concept to the test applying in the late 1960s and early 1970s when the then annuity value of assets at age pension age (around 10%) was effectively used as a deeming rate.

- Retain a separate assets test but reduce the taper (a taper of $1.75 per fortnight reduction for each extra $1,000 of assets would be broadly equivalent to a 9% deeming rate, and marginally higher than the current taper introduced after the Harmer Report).

Both options would still involve a firm taper, reducing age pension entitlements as assets increase, promoting an appropriate running down of accumulated assets. The taper would of course thereby reduce the net value of increasing those assets, but would leave some real benefits for those who accumulate more savings for retirement, consistent with the whole purpose of encouraging self-provision. The cut-out points in terms of assessable assets, which are the product of the maximum pension rate and the taper (and the free areas), would be higher but would also once again be more closely aligned with those under the current income test. The recent emphasis on the cut-out points is unwarranted as the key variables for adequacy, cost and incentives are the maximum rates and the means test tapers ($1 million in assets may seem high except that it only delivers an indexed annuity of under $50,000 a year, well below the income test cut-out point).

[11]These may change after the first year if the assessed assets in subsequent years change given the annuity purchased, depending on how the annuity is treated under the assets and income test. But the limited difference in total incomes despite the wide difference in accumulated assets is likely to continue.

[12] This is the initial impact. The subsequent impact will depend on the balance in the fund each year after the drawdown and after any earnings in the fund. It may be expected that age pension entitlements will increase as the balance declines, until the deferred annuity comes into play. The exact impact will of course depend on the fund earnings and whether and when the balance is exhausted. But the difference in incomes of those with $375,000 in assets from those with $825,000 will almost certainly remain slight (of the order of $10,000 a year).

The precise design could involve keeping current thresholds rather than increasing them to avoid budgetary costs, and retaining the current low deeming rate for low levels of assets (say, the first $100,000 or $200,000 of assets). Consideration could also be given to a concession for those purchasing lifetime annuities, applying the actual annuity (less any residual benefit) as income rather than the 9% deemed rate of income from assets.

Table 3 below illustrates how a merged means test with deeming at 9% above $200,000 might affect people at different levels of assets used in different ways, if annuities are treated simply as income.

This suggests such a merged test would strongly encourage people to draw down their assets, encouraging in particular CIPRs and annuities. Those doing so would also have more reasonable rewards from continuing to increase their savings (the marginal benefit for CIPR retirees being around double that under the new assets test). Finally, it would still achieve most if not all the short-term budgetary savings from the new assets test (depending on the threshold chosen) and, by encouraging longevity insurance, it would also reduce future calls on the age pension at very old ages.

Table 3

Impact of possible merged means test with 9% deeming above $200,000 assets (Couple with different levels of assets)

Assets $k	Minimum 5% drawdown, no CIPR			CIPR at 9% drawdown			Annuity at 5%		
	Pension	Super	Total	Pension	Super	Total	Pension	Super	Total
200	34,252	10,000	44,252	34,252	18,000	52,252	33,048	10,000	43,048
400	25,252	20,000	45,252	25,252	36,000	61,252	28,048	20,000	48,048
600	16,252	30,000	46,252	16,252	54,000	70,252	23,048	30,000	53,048
800	7,252	40,000	47,252	7,252	72,000	79,252	18,048	40,000	58,048
1,000	nil	50,000	50,000	nil	90,000	90,000	13,048	50,000	63,048

Suggested reforms for the treatment of housing under the age pension

As argued at the beginning of this Position Paper, all assets should be included in the pension means test. The value of the home is, in principle, no different to other forms of capital and savings. Providing there were means to access home equity in the form of cash payments of some kind so that pensioners continue to enjoy an adequate cash income, it would not be unfair to include the home in the pensions means test. The difficulty, however, is how to access that equity without reducing the cash incomes of pensioners of home-owning pensioners, as this would not be acceptable on adequacy grounds. This issue of how best to access the equity represented in a pensioner’s home is further discussed in a companion Position Paper on the Adequacy. The starting presumption in this paper is that any proposal to include housing assets in the means test will be accompanied by action to enable the pensioner to tap their equity in that home. Also people should not be forced to downsize and move, which means that tapping that equity would have to involve some form of financial product that provided for home equity release.

The Grattan Institute has estimated that over $20bn in age pension payments are made to households with substantial property assets, and that the exemption of the family home from the assets test amounts to an annual cost to the budget of around $7bn per year. In response there have been a number of proposals to bring housing into the means test for the age pension. Most have advocated that part of the value of the house should be exempt, but that part should be capped. Others have advocated no cap with the whole value of the pensioner's principal residence being assessed in the means test. Those proposals that favour a cap also propose that it should be indexed over time by either the CPI or by a house price index.

Essentially the choice of a cap reflects whether the priority is to improve equity or to make budgetary savings. Generally, proposals from official bodies and business have tended to favour a high cap, while proposals from independent "think tanks" have favoured no cap:

- The Henry Review proposed that only housing of 'significant value' should be included; possibly a then cap of $1.2 million

- The National Commission of Audit proposed that from 2027-28 the exemption threshold should be the indexed value of a house then valued at $750,000 for couples and $500,000 for single pensioners

- The Productivity Commission has given illustrative examples based on the median value of the principal residence – then about $440,000 in 2015.

- Two think tanks – the Grattan Institute and the Centre for Independent Studies have both proposed no exemption and that the full value of the principal residence should be assessed under the pension means test.

Those favouring no cap on the value of the housing that would be exempt recognise that to ensure an adequate income for the people affected, the loss of pension income would need to be offset by some form of access to their home equity, and they have favoured using a government provided reverse mortgage.

Exemption caps that are well above the median house value do not generate substantial revenue, and housing would remain concessional compared to other pensioner assets. Modelling by the Productivity Commission (2015:127) found that making the threshold equal to the median house value would result in 10.6 per cent of age pensioners experiencing some reduction in their pension[13]. While if a lower threshold equivalent to the very low assets free thresholds used for renters, then modelling by Wood et al. (2010) found that the gross saving (before any offsetting loans) would amount to $3.5 bn on the age pension alone, with a mean annual reduction of $2400 in pension payments.

Given the principle that no pensioner should actually experience a loss of cash income, it is proposed that in setting the exemption limit on the amount of housing equity to be included in the pension means test the following criteria should apply:

- the exemption limit should be set sufficiently high to allow the pensioner to raise sufficient revenue from some form of equity release product (ERP) that they can

[13] This relatively low proportion of pensioners affected may reflect the relative toughness of the pension assets test relative to the income test.

compensate their ongoing income for the loss of pension income, and

- the exemption limit should still leave sufficient housing equity that is unencumbered to meet the requirements for accessing residential aged care in the future if that became necessary.

What these requirements would actually imply in practice is further discussed in Appendix A, but the best guesstimate at this stage is that the exemption limit on the value of housing equity to be excluded from the pension means test would probably need to be quite high – possibly higher than the median value of housing. That would, of course, limit the amount that would be saved from the policy change. Although more modelling would be needed if this proposed change to include housing in the pension means test were to be seriously considered, a rough guess is that the amount raised using the above criteria might be of the order of $1 billion annually.

Some might consider, however, that there would still be a problem because there are large geographic variations in house values across Australia. Consequently, unless account is taken of these differences, including the value of the home in the means test could still result in major inequities according to where the pensioner lives. For example, the means test used for aged care includes the value of the home equity up to a maximum cap of $159,423.20 (as at 20 March, 2016), and this does disadvantage those owners who live in areas with low property values. By contrast, what is being proposed here, however, is that the cap should not represent a maximum value, but instead a minimum threshold over and above which the value of the home equity would be counted in the means test. In that case, if pensioners in Sydney have higher value houses on average, then they have more equity that they can draw down on, and as their actual pension payment would not be reduced, are they really disadvantaged relative to the pensioners where house prices are lower? While on the other hand, a pensioner with a low value home would either be under the exemption limit and not need to access their more limited housing equity, or even if they did, their pension would have been reduced by less, and they would need less replacement income by accessing their housing equity. Nevertheless, these equity concerns might be a further reason for proceeding cautiously, and setting the exemption cap quite high in any proposal to include home equity in the pensions means test, at least initially.

Another concern is that future generations may not have the same home equity that present retirees have. In that case, however, for those pensioners who in future do not have any home equity, the inclusion of home ownership in the means test could actually advantage them relative to the home owners.

Finally, a critical issue in incorporating housing into the pension means test is how much notice should be given, and what grandfathering arrangements might accompany any such proposal. The key consideration is that people should have adequate time to arrange their retirement plans, so that the changes cannot be claimed to be retrospective. Accordingly, and as a basis for discussion, it is suggested that no existing age pensioner should be affected by a change to include housing in the pension means test, and nor should any person who becomes eligible in the next 7 years be affected. In addition, the exemption cap should be phased in by gradually lowering it after the first year of introduction, reaching its final point in say 10 or 15 years, with a lower exemption level taking longer to phase in. This long period before the reform takes full effect will of course further reduce its budget impact for some time.

Means tests and the incentive to access home equity

Given that the proposal to include the pensioner's home in the means test is dependent on the pensioner being able to access that equity, another important issue is the willingness of pensioners to do just that.

Essentially there are two ways for retirees to access their home equity:

- Downsizing or rightsizing with the pensioner drawing down over time on the excess proceeds, representing the difference in price of the former home and the new home that better meets their current needs

- Provide older households with better forms of in situ equity release, with the most common such example being a reverse mortgage

At present very small numbers of retirees are using either approach to accessing home equity. For example, in 2015 the number of outstanding home equity release products in existence was only 40,000 nationwide, comprising just 0.4 per cent of the home equity of older Australians. There is a range of reasons for this poor take-up, but one possible reason is the operation of the pensions means test. For example, in the case of right-sizing the evidence seems to suggest that non-financial factors dominate the decision, particularly the desire of retirees to continue to 'age in place'. Nevertheless, the proceeds from right-sizing would be included in the means test, and other things being equal that would reduce their cash income. On the other hand, if an equity release product comes in the form of a loan, and that loan is drawn down regularly as income (say fortnightly) then it would not be included in the pension income test, but if the equity release product proceeds were paid as a lump sum then those proceeds would be counted under the assets test and deemed for the income test.

A critical question is how far the take-up of the different ways of accessing home equity would improve if the value of that equity were included as proposed in the pensions means test even if the pensioner hadn't accessed that equity. It is possible that the take-up rate of accessing home equity would then improve quite a lot, as pensioners would be forced to access that equity by buying some form of equity release product or by right-sizing if they didn't want to experience a loss of cash income. However, it is suggested that the government cannot afford to take any chances here, and government would be well advised to ensure that there are no other impediments to pensioners accessing their home equity. Indeed, the risk of asset rich but income poor pensioners becoming destitute because of the reduction in their cash income, following changes to the means test, might well be sufficient to discredit that policy.

On the other hand, even if no action is taken to include the value of the family home in the means test, it is still proposed that action should be taken to facilitate the access of pensioners to their home equity in order to improve the adequacy of their retirement cash flows. Such action would need to ensure that any additional funds released by buying an equity release product or by right-sizing were not then subject to the pension means test. The simplest way of making it worthwhile for a pensioner to access their home equity would be to exempt any consequent regular payments from the pensions means test up to some capped amount, providing these payments were derived from a loan (as now) or an approved equity release product (ERP). Similarly, in the case of right-sizing the proceeds could be exempt from the means test up to some capped amount provided it was invested in an approved retirement income product. In both cases the approved ERP would probably have to include some form of annuity or account-based pension payment for at least part of the proceeds. Furthermore, for the same reasons the means test for accessing aged care should be based on the remaining home equity after deducting the amounts that are encumbered by an ERP or an Aged Care Refundable Accommodation Deposit.

Changing the means test in this way to exempt the proceeds from accessing home equity might at first sight appear to make the pension system somewhat less financially sustainable from a national point of view. On the other hand, maintaining the status quo where pensioners do not access their home equity means that there is no income stream from home equity to means test (or tax) and so the reality is that this adjustment to the pension means test should not come at a cost to the Budget. Indeed, the Budget would gain from the reduction in pension payments if housing is included in the means test.

Appendix A

Considerations Influencing the Choice of the Exemption Limit if Housing Equity were included in the Pension Means Test

The first important consideration in setting the exemption limit for including housing equity in the pension means test is that this limit should not be set so low that pensioners could not borrow an amount against that equity sufficient to offset their loss of pension income. At present the statutory requirement for a reverse mortgage on a home is that the loan to valuation ratio (LVR) should be no greater than the sum of 15 per cent plus 1 per cent for each year of the borrower's age above 55. Thus for someone accessing the age pension for the first time at age 67 the maximum LVR on their home would 27 per cent. On a home with a value equivalent to the median value of around $500,000, this would secure a loan of $135,000. The maximum loss of pension income should not be more than would be offset by drawing down on the proceeds of that loan over the remainder of the pensioner's life.

The second important consideration is that many pensioners want to preserve their housing equity and would not be willing to draw it down because they fear that they might need to access this equity later on in order to enter an aged care facility. The acceptability of means testing housing equity may therefore depend upon being able to show that pensioners will not thereby be putting their future access to aged care at risk. This means that a pensioner needs to be able to access sufficient home equity to offset the loss of cash income from the change in the means test, while still preserving sufficient equity to enable them to later meet the financial requirements to access aged care.

At present many pensioners pay for their residential aged care by paying a refundable accommodation deposit (RAD). Most often the funds for this RAD are obtained by selling the home, but the RAD can be financed by a distinct type of reverse mortgage called an 'aged care loan'. Thus in 2014-15, 44% of those aged care residents not fully supported by the government preferred to make a lump sum payment to cover their accommodation charges and another 24% made a combination of a lump sum and a daily charge. And for those who relied only on a lump sum payment, the average cost of the RAD in June 2015 was $333,000 (Aged Care Financing Authority, 2015:ivi).

For the time being it would seem best to assume that someone entering residential aged care will on average need to draw down on their housing equity by as much as $333,000 for their RAD. In that case the exemption limit for the amount of housing equity included in the pension means test would best be set at a higher level than the amount that needs to be borrowed to meet the RAD plus the sum needed to offset the loss of cash income from the means testing of housing. Alternatively, if people accessing residential aged care cannot afford the full cost of the RAD, then they may rely more heavily on making daily accommodation payments, or failing that they would become more dependent on the government for to meet their accommodation charges. This would, of course, then reduce the net budgetary savings from including housing equity in the pensions means test. It is also another reason for being cautious and setting a fairly high exemption limit for housing equity in the pension means test.

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