



ASSA-TREASURY WORKSHOP ON RETIREMENT INCOMES POLICY

Overview by Andrew Podger

BACKGROUND

With the support of The Treasury, the Academy of the Social Sciences in Australia organised a half day workshop on 26 November 2014 to discuss the development of a coherent approach to retirement incomes policy particularly in light of various reviews now underway focused on other matters which are likely to affect such a policy, and also to identify the key issues that should be addressed. The reviews now underway that are relevant to retirement incomes policy are:

- The Financial System Inquiry (FSI) whose final report was released shortly after the workshop (a substantial interim report was released in September 2014);
- The Review of the Regulation of Retirement Income Streams (being conducted within Treasury and likely to contribute to the Government's response to the FSI); and
- The Taxation White Paper (also being conducted by the Treasury but to involve a public issues paper, a public Green Paper in 2015 and a White Paper in the lead-up to the election in 2016).

Participating in the Workshop at the invitation of ASSA were a wide range of academic experts, some industry people. Officials from Treasury and the Department of Social Services (DSS) also attended. To ensure frank and open discussion, it was agreed that individuals' comments would remain confidential but a summary document would be prepared by the Academy and made public. The discussion was informed by background papers including the interim report of the FSI and submissions to it by the Centre of Excellence on Population Ageing Research, ASSA's submission to the Review of the Regulation of Retirement Income Streams and ASSA's Academy Paper, "*Towards a Stronger, More Equitable and Efficient Tax – Social Security System*" released in 2013. Presentations were also made by Treasury, the Department of Social Services, Professor John Piggott FASSA (UNSW) and Dr Ross Clare (Association of Superannuation Funds Australia).

The views expressed below are those of the participants as interpreted by the author, and are not necessarily those of Treasury or DSS.

GENERAL ISSUES

The FSI's interim report highlighted the different approaches to the regulation of the accumulation of superannuation savings and the relative lack of regulation of the de-accumulation of those savings. From an economic efficiency perspective, it may be argued that a less-regulated approach (for example as applies in the de-accumulation phase) is preferable to a more highly regulated approach (as applies in the accumulation phase), but from a retirement incomes policy perspective the reverse may be the case.



Objectives

The argument for special treatment of superannuation savings as distinct from other savings is based primarily on the achievement of retirement income policy objectives. As the background papers highlight, there are two central objectives:

- The alleviation of poverty amongst older Australians (mainly achieved through the age pension); and
- The maintenance of living standards at and through retirement (mainly achieved through mandatory and voluntary superannuation savings arrangements which help people to spread their lifetime income and consumption).

Strengths and weaknesses of Australian arrangements

There are considerable strengths in Australia's 'multi-pillar' approach which has attracted some support from international bodies such as the OECD and the World Bank. Using the World Bank's terminology, Australia's foundation pillar (the means-tested age pension financed from general revenue) addresses the first objective quite efficiently and hence presents reasonably manageable challenges from population ageing. Unlike most European and North American countries, Australia does not rely on a 'pillar-one' national superannuation scheme with unfunded promises of future benefits which presents very considerable financial challenges for those governments from population ageing. Instead, Australia has 'pillar-two' mandated superannuation savings and 'pillar-three' tax-encouraged voluntary superannuation savings which are (mostly) fully-funded, so that individuals bear more of the risk than governments. Potentially, such a system is more flexible and limits the risks to government and future taxpayers.

Notwithstanding the potential strengths of the Australian approach, there are significant weaknesses, particularly concerning the effective and efficient achievement of the second objective. The complexity of the system and level of risk borne by individuals means that people may not be spreading their lifetime incomes effectively and thereby maintaining their living standards at and through their retirement. Individual circumstances also vary widely and the system may not serve some very well, particularly those who have interrupted careers or spend significant periods doing unpaid work (particularly women) or lack the skills and capacity to work through to age pension age. Moreover, the tax support is substantial and may present a financial challenge for government into the future. These problems are most apparent in the de-accumulation phase which was the main focus of discussion at the workshop.

DE-ACCUMULATION PHASE ISSUES

Age pension indexation

While the means-tested age pension is seen as a strength in the Australian retirement incomes system, considerable concern was expressed about the Government's decision to index payments on the basis of the Consumer Price Index (CPI). It was recognised that the current use of Average Weekly Ordinary Time Earnings (AWOTE) does presents problems – with an ageing population it is likely to increase faster than average per-capita disposable incomes – but using the CPI alone will lead to very substantial reductions in the level of the pension relative to community incomes over



the long-term. This will be most apparent to the public if the Government applies the new policy strictly in the analysis for the next Inter-Generational Report in February 2015. Most people would expect the first objective of the retirement income system (the alleviation of poverty) to mean setting a minimum income level relative to prevailing incomes in the community. The Government needs to clarify therefore, whether it is proposing that the age pension fall to a new level relative to community incomes (and if so, what that level is), and how it might subsequently maintain that level.

The reliability and frequency of the CPI makes it a suitable index for automatic adjustments to pensions, protecting people from reductions in their purchasing power, but additional adjustments are required from time to time if pensions are to maintain their position relative to community incomes. Various options were mentioned at the Workshop including annual, biennial or three-yearly reviews required by legislation that might draw on a range of indicators of community income changes such as per capita Gross National Income. It was also noted that this issue applies to other social security payments as well, including Newstart.

Addressing complexity

The complexity of the superannuation system and the limited guidance and regulation of payments from superannuation savings was the focus of much of the discussion. There is evidence that even financial advisers struggle to understand the complexity of tax and social security rules affecting payments, and of the array of products available. Furthermore, there may not be any incentive for them to do so. The problem for older people, particularly as their cognitive ability declines, is likely to be much greater.

This raises a dilemma: how to balance the advantages of flexibility against the dangers of complexity. There were some differences of opinion amongst participants. Just as concern about myopia form the rationale for mandatory superannuation contributions, concern about continued myopia and cognitive decline might justify a heavily regulated approach to retirement benefits. This, of course, is the rationale behind the national benefits-promise superannuation schemes in Europe and North America which involve much lower costs of administration but impose significant financial challenges on governments (and have long been rejected by Australian Governments).

The approach favoured by most participants, reflected in the CEPAR submission to the FSI, involve wider use of 'default' arrangements to guide people, and some limited mandating.

Put another way, just as the World Bank and OECD advocate that countries with national benefits-promise superannuation schemes might use fully funded models such as Australia's to guide the way they set contributions and benefit entitlements, Australia might make more use of those schemes' approaches to defining retirement benefits and their adequacy as a way of setting benchmarks to guide people as they make choices regarding both accumulation and de-accumulation of savings. Instead of the current emphasis on the level of capital achieved and on investment returns, Australians should be encouraged, when planning retirement, to consider the income replacement rate they desire and the continuing income they need for the remainder of their lives.



Specific suggestions included changing default options during the accumulation phase as people near retirement, and providing guidance on optimal withdrawal rates from allocated pensions (rather than just the statutory minimum to gain tax advantage), and appropriate default investment arrangements during the early post-retirement years.

Longevity risk and deferred annuities

The role of life-time annuities and the management of longevity risk attracted considerable discussion. On the one hand, lifetime annuities are seen by most people to be poor investments at present and are rarely purchased. In part, this reflects a lack of understanding that life-time annuities represent an insurance product and not just an investment product to be compared to other investment products. Such insurance can only be efficiently covered through pooling, and in a form that limits the risk of adverse selection. Arguably it also requires government intervention to facilitate market trade in the risk, such as through the provision of longevity bonds or other long-term indexed bonds that might reduce the impact of current regulatory provisions designed to protect institutions' financial sustainability which in practice presents a barrier to affordable lifetime annuities.

The CEPAR submissions propose both the introduction of longevity bonds or similar financial instruments, and the mandating or defaulting of deferred annuities to be purchased when de-accumulation begins and to commence payment at, say, age 85. What proportion of accumulated savings should be directed into a deferred annuity was not discussed, though it was suggested that the compulsion only apply when total savings exceed some threshold.

This arrangement was also seen as a way to reduce reliance on the age pension as insurance against longevity by those with the ability not to rely on taxpayers, and also to counter overly conservative behaviour (that seems to be widespread) of not drawing down accumulated savings but allowing them to increase and to be left in estates to the next generation. Requiring the purchase of a deferred annuity would also address the problem of adverse selection. The encouragement or mandating of deferred annuities might also require adjustment to age pension means test arrangements to ensure there is no inappropriate penalty involved.

Another option identified, also mentioned in the CEPAR and ASSA submissions, is for the government to offer for sale supplementary age pensions from, say, age 85 (a form of deferred annuity). These would need to be treated like any other lifetime annuity for the purposes of the basic age pension means test.

Limiting bequests

Whether there should be any restriction on the use of tax-supported superannuation savings for bequests was also discussed. On the one hand, to the extent that the superannuation system is simply a mechanism for spreading consumption over lifetimes, and that bequests are just another form of voluntary consumption, there would be little reason to constrain their use for this purpose. On the other hand, a focus on the core objectives of the retirement income system, and evidence that bequests are often unplanned and are the result of poor management of accumulated superannuation, suggests a more restrictive approach such as through mandating deferred



annuities. Concern was also expressed that rising levels of bequests funded from taxpayer-supported savings might accentuate wealth inequality into the future. That said, it was noted that the main element of bequests were owner-occupied housing that is also a tax-favoured form of savings.

Guidance and benchmarking for different groups

The suggestion for more guidance and benchmarking also included provision of better information to people in different financial and health situations, as well as at different points in the life-cycle. Thus, for example, guidance should vary for those who might be expected to be totally self-funded, those likely to rely in part on an age pension (and hence need advice on the means test) and those likely to rely very heavily on the age pension.

Age pension age and preservation age

While there was no detailed discussion about the preservation age or the age pension age, it was noted that the system needed to recognise that the transition from work to retirement is increasingly a prolonged process and not a point in time event. This might suggest retaining some gap between the preservation and age pension age, during which people may choose when they shift from accumulation to de-accumulation, or even do a bit of both. The system also needs to recognise that there is considerable variation in capacity to delay transition out of the workforce, and that pressing people to work to age 70 might not necessarily enhance their wellbeing or that of the community.

ACCUMULATION PHASE

While most of the discussion was on the de-accumulation phase, there was also some consideration of key elements concerning accumulation.

Tax treatment of superannuation savings

The issue of different tax treatment of different forms of savings was addressed in the Henry Report and will be considered again in the Tax White Paper. While the various tax arrangements may have some net effect on the total level of savings, the main impact is to distort the direction of savings which is likely to impose efficiency costs. Arguably, a comprehensive consumption tax approach is the most appropriate basis for taxing longer-term savings. Against this benchmark, superannuation attracts significant tax advantages (the tax advantage over other forms of saving, except owner-occupied housing, is even more pronounced). Applying the benchmark strictly, however, would present substantial political and technical difficulties.

In the case of superannuation, it would now be very hard to move to a direct consumption approach (exempting contributions and earnings, and taxing in full all benefits as income) unless a fifty years or more transition to such an approach was seriously considered to be feasible. A broadly equivalent approach was suggested in the Henry Report involving a progressive tax on contributions and an easing of the tax on earnings, with a standard approach to taxing earnings through both the accumulation and de-accumulation phases. Such an approach would address the widely-perceived inequity of the current tax arrangement. Reference was also made to the questionable role of



superannuation funds accessing franking credits when the market for equities is now very much international.

Compulsory employer contribution rate

There were mixed views on the level of the mandated contribution rate. The current rate (9.5%) is below the level needed by most people over their working lives to finance a retirement income commensurate with their pre-retirement standard of living. This is the argument ASFA has used to support increasing the mandated contribution to 12% or 15%. But, such mandated contribution rates would force substantial savings at times when people might have good reason to consume more, such as when they have young children to care for or are in households that must live on one income for other reasons. These considerations may add weight to suggestions for a lower mandated contribution rate, allowing greater flexibility over when and how to save more voluntarily, together with clearer information and guidance. Thus, for example, the mandated level might be left at 9.5% and clear benchmarks provided regarding target accumulation levels to fund desired income replacement rates (or desired retirement income levels) at a desired retirement age together with guidance about the future contribution rates needed to achieve these targets given individuals current ages and accumulated savings.

The argument to increase the mandated level to 12 per cent or 15 per cent to guarantee incomes in retirement closer to that needed to maintain living standards would necessarily constrain flexibility and choice, on the basis that people are myopic and do not know what is good for them. It was pointed out on the other hand that, bearing in mind the high administrative costs of Australia's arrangements, its complexity and the risks left to individuals to manage, such an argument might just as easily be used to support a government managed national superannuation scheme – an approach no-one was seriously proposing.

Contribution caps

Arguments about placing limits on contributions cannot be separated from the way final benefits are paid and used. If the benefits are more firmly directed to genuine retirement income purposes limiting people's ability to use superannuation as a tax haven for savings intended for other purposes (including bequests), the case for such limits is considerably reduced. A progressive tax regime on contributions would also constrain misuse and inequity in the system. Capping the earnings on accumulated savings (or imposing tax penalties on higher earnings) as proposed by the previous Government would be administratively complex and likely to lead to anomalies as investment returns vary and fluctuate. The current annual contributions caps also represent a crude approach, and are arguably inconsistent with the flexibility inherent in having a mandated contribution well below the average level required over most people's working lives to maintain living standards in retirement.

In theory, more appropriate forms of caps would relate to the total amount of accumulated savings, and would vary with a person's pre-retirement income (assuming the objective of maintaining living standards applies at all life-time income levels). A simplified version of this would be to have a fixed lifetime savings cap (say, \$2.5million as suggested by ASFA), though this would not be consistent with allowing high income people to spread their incomes and consumption (noting they would



already pay more tax under a progressive tax on contributions). The current approach involving fixed annual caps (varying with age) has the advantage of simplicity but, in addition to the weaknesses of a fixed lifetime cap, it may constrain people from 'catching up' after years of limited contributions when they are in a good position to do so (at a standard contribution of 15 per cent, the current cap - \$35,000 for older people - affects all those with an annual income of \$240,000 or more; those on lower incomes trying to 'catch up' are also affected). This is a particular problem for women who often have long periods out of the paid labour force because they have a greater share of caring responsibilities, especially for children.

RESEARCH AND DATA

While some evidence is emerging about the way people are choosing to accumulate and use their superannuation savings, more research on trends and on patterns of behaviour amongst different groups (e.g. by earnings levels, marital and family status etc.) would provide better guidance for policy makers. Assurances were given by officials about improving access to administrative data which might allow more longitudinal studies to be undertaken, complementing existing data sets such as HILDA.

CONCLUSION

There was wide support for the Government to draw on the reviews now underway, to develop a more coherent and comprehensive retirement incomes policy and one that suits Australia's emerging demographics. These involve not just an ageing population in which older people are living longer, but also one in which most people have more years of healthy living during which they wish to engage actively in society and continue to contribute; there is also increasing variability in older people's mix of workforce participation, unpaid work and leisure, and in their mental and physical health.

A coherent and comprehensive retirement incomes policy should have the capacity to respond appropriately to different people's circumstances, and to future demographic changes, but it also needs to have an enduring quality: individuals must have confidence as they make their decisions, including on work and saving, about their long-term income security. A coherent policy will also complement other related policies such as on health, aged care and housing.

These considerations all point to the need for considerable public engagement as well as expert analysis and, preferably, the development of a bipartisan view.

It was recognised that a retirement incomes policy needs to fit into the context of short, medium and long-term pressures on the budget. It also needs to take account of the Government's existing political commitments and policy announcements, and its desire to limit 'red tape', as well as practical considerations such as administrative feasibility. A coherent policy might require some adjustment to some of these constraints, adding to the imperative for wide consultation.

There are several options for developing the policy, including a largely internal process initially which could draw on the other reviews (particularly the FSI which has already involved an extensive public



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process). Whichever approach is adopted there will need to be opportunity for considerable public education and engagement.

The Academy is willing to continue to assist with arranging public or private forums for exploring the research and other evidence that might inform further policy development.

Canberra
December 2014

