

Committee for Sustainable Retirement Incomes Submission

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About CSRI

The Committee for Sustainable Retirement Incomes Policies (CSRI) is an independent, non-partisan, non-profit organization committed to improving the adequacy and sustainability of retirement incomes.

It pursues its mission by acting as a catalyst for public debate, and the development of evidence-based policy and advocacy.

The CSRI recognizes that the Australian system of retirement incomes has considerable strengths, but there are also significant possibilities for further improvement that could also enhance the sustainability of the system.

To achieve this aim, the Committee adopts a highly consultative approach, actively seeking contributions from all stakeholder groups and encouraging all competing viewpoints to be heard.

The Committee comprises:

Dr Michael Keating AC (Chair) - Former Secretary of Departments of Prime Minister and Cabinet, Finance, and Employment and Industrial Relations.

Dr Vince FitzGerald - Director Acil Allen Consulting, Conversation Media Group, ETF Securities Limited; Former Secretary of two Federal Departments, co-founder of Allen Consulting Group, author of the National Saving Report and a number of reports on superannuation and retirement incomes

Professor Bob Officer AM - Prof Emeritus University of Melbourne; chair of a number of fund management firms; formerly Chair of National Commission of Audit, VFMC, Victorian Work Cover and director of Bank of Melbourne and Transurban.

Ms Patricia Pascuzzo - Founder and Executive Director, formerly adviser to government and investment funds globally, including Australian Future Fund establishment, adviser to superannuation and pension fund boards; and Federal Treasury official.

Professor Andrew Podger AO - Former Public Service Commissioner and Secretary of Departments of Health and Aged Care, Housing and Regional Development, and Administrative Services.

Ms Elana Rubin - Director of Mirvac Group Ltd, MLC (Life and Administration & Asset Management boards) and Transurban Queensland (QML); a member of Qualitas Property Advisory Board, AICD (Victoria) and Committee for Melbourne.

For further information see www.csri.org.au.

Executive Summary

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

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

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

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

Goals and Principles

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

- Broadness and adequacy, incorporating both an adequate income guarantee to protect people from poverty in old age and adequate income maintenance at and through retirement;
- Fairness and acceptability, where assistance is targeted and incentives to work and save are retained;
- Robustness, with risks allocated in a way that government and individuals can reasonably manage, balancing flexibility and stability;

- Simplicity and certainty, so people can plan their retirement and manage their savings with confidence; and
- Sustainability, including both financial sustainability for government and continuing community support for the system.

Reform Direction

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

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

There will need to be constructive discussion of the inevitable trade-offs involved in designing a reform package if it is to deliver adequate and sustainable retirement incomes. An illustrative reform package is presented that demonstrates the nature of the tradeoffs involved. A gradual approach to implementation should be pursued to minimise any disruption to existing retirement plans.

1. Introduction

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

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

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

The Government's response to the Financial System Inquiry (FSI) Report and the foreshadowed Tax White Paper, offer scope to address some of the issues, insofar as they cover the tax and superannuation system. However what is missing is an overarching perspective of the retirement income system as a whole – covering the age pension system, the superannuation system and the tax system.

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

The outline of the paper is as follows. Section 2 discusses framework issues: more specifically, it reviews the role of government in retirement income policies and the stated rationale for the introduction of the superannuation system. This provides context for consideration of an appropriate set of goals and objectives for the retirement income system.

Section 3 discusses the principles that should inform the assessment of the retirement income system and proposed reforms. Section 4 explores the weaknesses of the current system, considering the pension system, the superannuation system (from accumulation through to post retirement) and their interactions. Section 5 canvasses possible directions for reform with an illustrative reform package that might be developed for gradual implementation.

2. Framework issues

2.1 The Three Pillar Retirement System

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

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

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

This three-pillar approach has considerable theoretical strengths:

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

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

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

We agree these theoretical benefits of the system, but also note that in practice the system currently also has a number of limitations. These limitations, as discussed in Section 4, arise to some extent from the tendency to treat each pillar independently of others even though their interaction has a significant influence on outcomes.

2.2 Rationale for Government Intervention

The classic rationale for Government intervention in the economy – the market failure and redistribution or equity arguments – also have their application in the promotion of retirement savings.

A key argument is that myopia leads people to undervalue their future wellbeing and that government should intervene to promote the ‘superior good’ of individuals’ future retirement income and consumption; the complexity of long term financial planning

exacerbates the failure by many to initiate and execute a retirement plan. An associated market failure argument is that the nature of longevity risk and adverse selection in the demand for income streams, as well as inadequate means to hedge supplier risks, cause a lack of appropriate retirement income products at a reasonable price, justifying further forms of government intervention. A related 'government failure' argument (specific to Australia) is that distortions from other public policies, including the double taxation of saving and the concessional tax treatment of owner-occupied housing, also necessitate some compensating government intervention in respect of retirement – as a 'second best' solution.

The 'redistribution' argument arises in cases where the consequences of an unfettered market are considered unacceptable from an equity perspective. Specifically in relation to retirement, there are those in the community whose lifetime income is too low to enable sufficient saving for retirement so that some form of government safety net is called for to alleviate aged poverty and promote social cohesion. Another equity argument is an intergenerational one, that those who could contribute to the funding of their own later retirement should not leave an undue burden for their support after they retire to a later generation.

2.3 Purpose of Superannuation

In introducing the Australian superannuation guarantee system, the then Government acknowledged the broader economy-wide arguments in favour of boosting national saving and preparing for an ageing population. The rationale for the introduction of the superannuation system relied on a number of key macroeconomic planks.

First, there was a view, strongly supported by the trade union movement, that too many Australians were solely dependent on the age pension in their retirement. The principal concern was that, because only a modest living standard is possible on the age pension, this reliance on the age pension represented too large a drop in post-retirement incomes for many middle-income Australian workers.

Second, there was a national saving argument. The introduction of a mandatory saving system complemented by a voluntary saving scheme in long-term vehicles would, it was argued, help to check Australia's reliance on foreign savings. The extent to which the superannuation system stimulated an increase in national saving rather than a substituted form of savings is debatable, but Treasury estimates suggest that household saving may currently be 1.5% of GDP higher as a result of the introduction of the superannuation guarantee (Gruen 2014).

There was also a fiscal policy and intergenerational equity argument: as the population ages, increasing demands for the age pension and health services will generate significant fiscal pressures. At the same time, the proportion of the population of working age will contract relative to the growing 'dependent' portion of the population. According to this argument, greater self-provision for retirement by individuals is needed during their working years so that they impose less of a burden on future generations.

There have been significant changes to the superannuation system since that time; some of which have not been mutually reinforcing. Indeed, numerous changes have

been made to the system in recent years based on short-term budgetary or political circumstances and these inevitably create some future uncertainty and have not helped build confidence in the system. What is notable therefore is the need for a more clearly articulated framework of goals and objectives to guide superannuation policy development in the context of retirement incomes policy overall.

2.4 Goals, Objectives and Instruments

2.4.1 Retirement Incomes System

In 2013, the then Government set up the Charter Group to develop and recommend a Charter of Superannuation Adequacy and Sustainability that would serve to guide future changes to the superannuation system.

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

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

It is very hard to make and sustain good policy if the public is confused about the objectives of that policy. And in the case of the retirement income system there is an unfortunate lack of clearly articulated and authoritative goals and objectives. Furthermore, articulation of goals and measurable objectives for the whole retirement income system, including both superannuation and the age pension, which are then recognized by government, would assist in providing a framework to guide future policy development and ensure the coherence of the whole system is achieved and maintained.

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

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

- sustainable, in that it is financially sound and detracts as little as possible from economic growth.

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

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

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

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

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

What constitutes such an “adequate” income, however, varies according to circumstances. For those people who have not been able to provide for themselves in retirement an adequate income must be defined relative to community norms. The minimum objective for those people who need to access a social safety net should be to alleviate poverty in old age. For the majority of people, what constitutes an adequate income in retirement will normally be considered relative to their past income while they were working and what is necessary to maintain their previous living standards (encompassing the spreading of lifetime incomes and consumption).

The role of government in facilitating the goal of the retirement income system would then be constrained or complemented by other concerns, described as principles, including broadness and adequacy, fairness and acceptability, simplicity and certainty, and sustainability, as discussed in Section 3.

3. Principles

In determining a set of principles for the purpose of evaluating the performance of the retirement incomes system, consideration has been given to previous articulations provided by the Retirement Income Consultation Paper (2009) (referred to hereafter as the Henry Review) and the Charter Group (2013). The principles espoused by the Committee are:

- Broadness and adequacy;

- Fairness and acceptability;
- Simplicity and certainty; and
- Sustainability.

These principles represent interconnected criteria that need to be applied in a holistic manner in evaluating the performance of the retirement income system as discussed in the following section.

3.1 Broadness and Adequacy

What constitutes an adequate income for a retiree and other aged persons is of course a subjective concept, and varies significantly according to individual circumstances, such as their family and housing arrangements as well as their health demands. Nevertheless, measures have been devised by various groups to assess adequacy of retirement incomes in and through old age. Broadly speaking, poverty in advanced economies is considered to be relative to what are community norms, as measured by what other peoples' incomes are. Income maintenance is considered relative to the past living standard of that particular household.

Adequacy for poverty alleviation purposes is thus commonly defined in terms of a minimum income relative to community incomes. There are no universally accepted benchmarks (e.g. the OECD and World Bank each have their own definition of adequacy). A commonly used threshold for aged poverty is 50% of median income: people below this line are widely considered to be 'at risk of poverty' (Burnett et al. 2014).

'Income maintenance' adequacy is commonly defined in terms of the income replacement rate, the ratio of post-retirement income (or consumption) to pre-retirement income (or consumption) (Burnett et al. 2014). There are several approaches to defining 'adequacy' for income maintenance. Countries with national mandatory savings schemes with government defined benefits use benchmarks in terms of income replacement rates, typically between 70 and 80% of pre-retirement earnings. Setting such benchmarks may depend upon factors such as home ownership and definitions of income, and may vary with levels of pre-retirement income (e.g. lower at higher income levels including because of greater wealth and progressive income tax arrangements). Consumption needs also vary with age, typically dropping at older ages before increasing again as health deteriorates (though in Australia this increase is primarily funded by government).

An alternative way of measuring retirement income adequacy is to compare projections of consumption that will be financed in retirement relative to a target consumption level. This involves setting some specific income levels that are likely to support a 'basic' or 'comfortable' lifestyle for the majority of the population.

In comparing the two measures, research indicates that the actual income replacement rate tends to be higher for low-income groups, while high-income groups have higher consumption relative to their expected consumption (Burnett et al. 2014). This suggests that any consideration of adequacy must carefully consider how 'adequacy' is best measured, and/or provide more than one measure.

In assessing the outcomes of the current retirement system in terms of retirement income adequacy and poverty alleviation, conclusions depend both on the measures and benchmarks used (as outlined above) and on the timeframe over which the assessment is made. In particular, compulsory savings through the superannuation guarantee have only been introduced a little over twenty years ago in Australia and it will take another twenty years or more before the system reaches maturity and pays the full retirement incomes that will be possible from superannuation savings accumulated through a full-working life. For that reason the assessments of adequacy that follow refer not only to the present situation, but also to projections of retirement incomes out to 2035.

Generally the cost of living is somewhat lower in retirement than when working – often the housing costs are lower as the mortgage has been paid off, no children are living at home, and there are no costs of working such as travel. For these reasons most countries target income replacement rates that are less than 100%, with a range between 60 or 70 and 80% being usual. If a rough judgment is needed on what is an adequate net income replacement rate (ie comparing after tax incomes in both periods), then around 70 to 80% would seem to be appropriate.

In terms of poverty alleviation, estimates suggest that 35% of aged Australians in 2010 received incomes below 50 percent of median income compared with a 12.5% OECD average (OECD 2013). This reflects the high proportion of retirees who rely on the full rate pension and the fact that the level of the pension is below 50% of median income. Those 35% have incomes typically only 12.4% percentage points below the benchmark, however, compared with an OECD average of 18.4% (OECD 2013). That is, the severity of ‘poverty’ is slightly lower in Australia. Moreover, evidence suggests that the proportion of retirees who are full rate pensioners is projected to decline further to 30% by 2047. (Henry Review 2009; IGR 2010; Productivity Commission 2014).

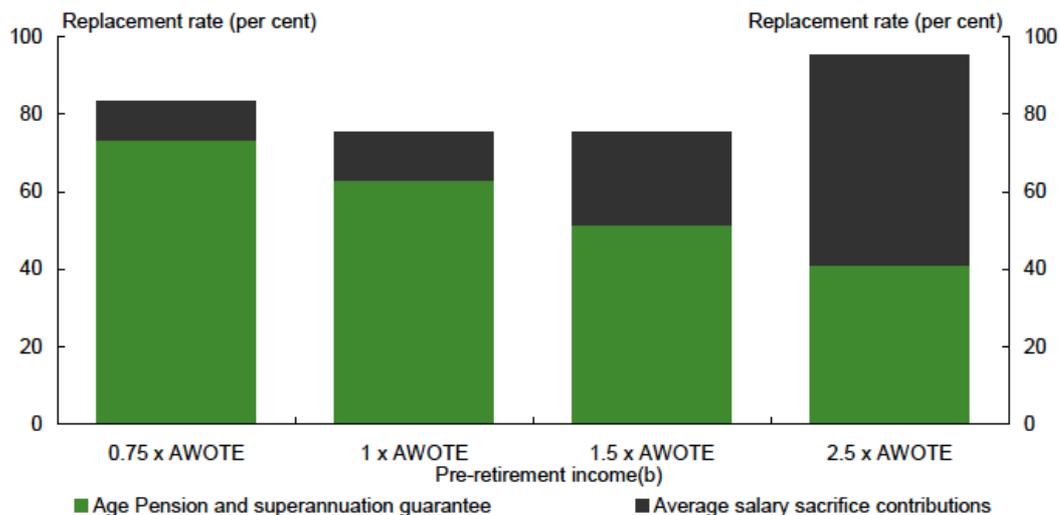
OECD (2013) provides data on net replacement rates for full career workers entering the labour market in 2012 at different earnings rates relative to the economy-wide average. These replacement rates are therefore forward looking and apply to future entitlements assuming that current rules will apply throughout their careers until they reach the standard pension age. These estimates are based on the then government policy of increasing the mandated contribution level from 9% to 12% in 2021-22. The OECD’s projected net replacement rate¹ at 65 is 67.7% for those on average earnings with lower rates for those on higher incomes (e.g. 54.3% at 1.5 times mean incomes) and higher rates on lower incomes because of access to some age pension.

Including voluntary savings further improves outcomes on average, particularly at higher incomes. Chart 1 from the Henry Review shows illustrative replacement rates for a hypothetical individual who salary sacrifices into superannuation at the average rate for an employee of their age and level of remuneration (it does not include non-superannuation saving). It estimated average replacement rates of 75% for those previously earning 1.5 times average income and almost 100% for those previously

¹ Assumes worker has joined the workforce in 2012 and works continuously for 30 years. Also assumes future changes in the arrangements are introduced as per current government policies in 2012.

earning 2.5 times average incomes (Chart 1). This suggests that when the retirement income system reaches maturity, the combination of compulsory and voluntary elements of the superannuation system, supported by the pension safety net, will facilitate income replacement of 75% or more across the income range for those with 35 years of full-time work.

Chart 1: Illustrative projected replacement rates including the Age Pension, superannuation guarantee and average salary sacrificed amounts for employees^(a)



(a) A replacement rate compares an individual's spending power before and after retirement (that is, after tax is paid). For example, a replacement rate of 75 per cent would mean that an individual would be able to spend in a given time period \$75 in retirement for each \$100 spent before retirement. The illustrative replacement rates are projected for a hypothetical single person who works for 35 years and retires in 2035, making average salary sacrifice contributions for an employee of their age and level of salary and wage remuneration. It is assumed that at age 65 years they retire and use their superannuation guarantee benefit to purchase a lifetime annuity. The incomes used to calculate the illustrative replacement rates are deflated by the consumer price index to 2008-09 dollars. Projections are of disposable income, after tax and means testing are taken into account. Actual outcomes will vary depending on factors such as workforce participation, labour income patterns, investment performance, inflation, longevity and whether an individual accesses their superannuation prior to Age Pension age.

(b) AWOTE is average weekly ordinary time earnings and is around \$1,150 per week (\$60,000 per year). Around half of workers earn less than three-quarters of AWOTE.

Source: Henry Review (2009, p 26) based upon Treasury Projections.

The reason for this projected outcome is that people on higher incomes also generally undertake higher levels of voluntary saving via superannuation, i.e. through the third pillar, and outside superannuation. While this projection was made before the current caps on contributions were in place, the estimates are not very sensitive to the contribution caps as they are based on average salary sacrifice contributions over a lifetime of earnings rather than maximum contributions.^{2 3}

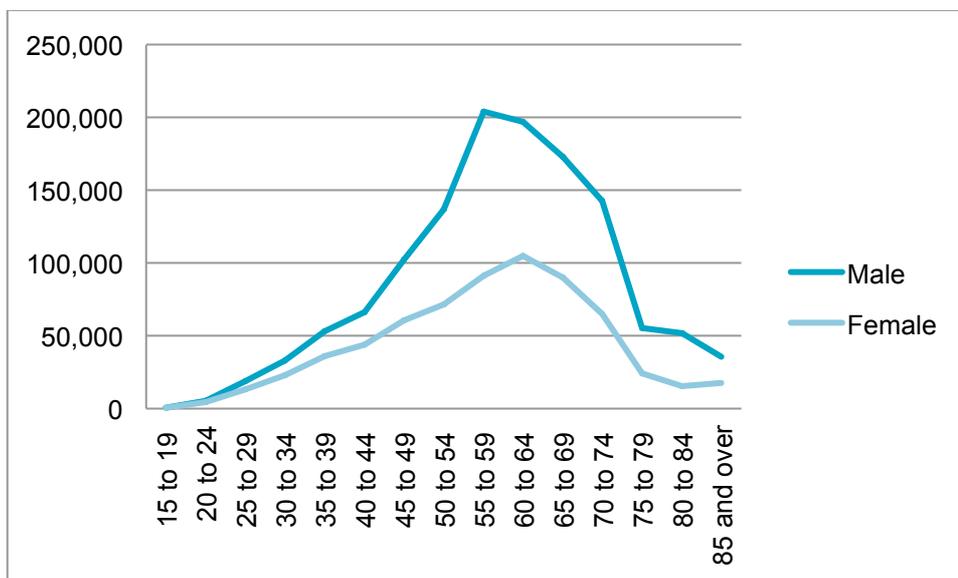
² Limit on concessional contributions (formally known as tax deductible contributions) reduced from \$50 000 p.a. to \$25 000 p.a. for 2009-10 and later years. This limit is indexed to changes in AWOTE (if those changes are sufficiently large enough). Transitional measures remain in place for those over 50 years of age to 2011-2012. Annual limits on non-concessional contributions (i.e. after tax contributions) are now 6 times the limit on concessional contributions for those under 50 years of age (i.e. 6 times \$25 000 or \$150 000 p.a. for the 2009-10 year).

³ We note that in the above chart, it is not clear to us whether for the highest income category, the 'average salary sacrifice contributions' component includes non-concessional contributions.

The exclusion of the self-employed from the SGC significantly reduces the coverage of the second pillar, with most self-employed not making voluntary contributions. While some may have wealth accumulated in their business that may be used ultimately for retirement income purposes, most do not. Specific capital tax exemptions for small business owners facilitate this in many cases.⁴

Workforce participation and patterns of employment are important determinants of superannuation guarantee and voluntary savings and retirement incomes. Groups with interrupted work patterns and permanent part-time workers would tend to have lower retirement incomes reflecting their lower incomes and lower superannuation contributions over their working lives. In the main, women still earn less than men and are more likely to have interrupted work patterns. As a result, women have lower superannuation account balances than men. Average super account balances were \$82,615 for men and \$44,866 for women in 2011-12 (inclusive of zero account balances) (Clare 2014).⁵ Chart 2 illustrates this disparity across age cohorts, with the size of the difference in average males' superannuation balance and that of females' peaking at ages 55-59 (Clare 2014).

Chart 2: Mean superannuation balances (\$), 2011-12



Source: Clare (2014, p 8).

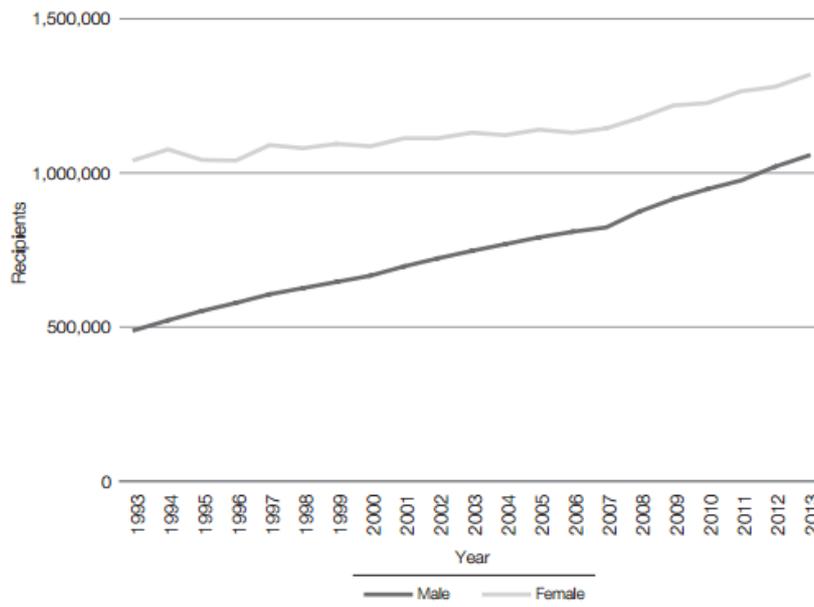
While these differences do not take into account the sharing of superannuation savings amongst couples, not all women have access to a partner's superannuation and such sharing may not fully compensate for their own lower balances.

⁴ Capital gains tax exemptions exist on the sale of a small business where the business has been held for 15 years and the person is retiring or the person is aged 55 years or older and the proceeds from the sale of a small business are paid into a complying superannuation fund, an approved deposit fund or a retirement savings account in certain circumstances (up to a lifetime limit of \$500,000).

⁵ With the omission of zero account balances, the disparity widens with the average balance for males at around \$112,000 while for females it is around \$68,600 (Clare 2014, p 3).

With this in mind, it is worth noting that women are more reliant on government income support. DSS estimates (2015, p 5) shown in Chart 3 shows that there are more female recipients of the age pension than males, reflecting both their longer life expectancy and their lower non-pension incomes and assets.

Chart 3: Age Pension recipients by sex, June 1993 to June 2013⁶



Note: Includes Age Pension payments administered by DHS and DVA.

Source: DHS and DVA administrative data.

Source: DSS (2015, p 5).

While these projections may provide some level of comfort about ‘adequacy’ outcomes of the present system once it has fully matured, it raises a number of important questions:

- First, whether the accumulated savings are indeed directed towards delivering the adequate retirement incomes they potentially can deliver.
- Second, whether those with different employment histories have access to adequate retirement incomes.
- Third, whether the system design is acceptable from the perspective of equity and fairness.
- Fourth, whether the present design of the system is fiscally sustainable, or at least optimal, particularly when account is taken of broader pressures on the budget.

⁶ The slower growth in female recipients reflects the phasing out of age pensions for women aged 60 to 64.

- Finally, given the current cost of the system, whether recalibration of the system design could achieve the projected levels of adequacy at a lesser cost and/or ensure wider achievement of adequate retirement incomes.

3.2 Fairness and Acceptability

Assessing the fairness of the retirement income system is a highly complex exercise that needs to take into account interactions with the broader tax and transfer system. Further, as highlighted by the Henry Review (2009, p 27):

“The assessment should consider the outcomes for individuals and families over their lifecycle, and between generations, including between future retirees and those taxpayers who will be funding the Age Pension and other publicly provided benefits. Basing the assessment on a subset of policy settings at a point in time may be misleading.”

Measuring the tax concessions, or tax expenditures, for superannuation is not straightforward. Currently contributions and earnings during the accumulation phase are taxed at 15% but income in pension phase and withdrawals are tax-free. Treasury’s standard approach is to measure the cost to revenue as the difference between the taxes on contributions and earnings and the total tax that would be payable if these were treated the same way as personal income from which most other savings are made: that is, were contributions treated as income and taxed at individuals’ marginal rates, and earnings in superannuation accounts similarly taxed.

This benchmark approach is called a ‘comprehensive income’ basis or ‘TTE’ (full tax on contributions and on earnings at all stages, but with final withdrawal of the savings exempt from tax). On this basis, the estimated tax expenditures for superannuation are more than \$30 billion a year and are expected to increase to \$50b in 2017-18 (Tax Expenditure Statement 2015, pp 64-65). Treasury also produced a second estimate in 2014 based on a ‘comprehensive consumption’ tax basis (or TEE) where contributions are taxed fully at marginal rates but the investment return is exempt, as is final consumption. This is the way owner-occupied housing investment is taxed and leads to a figure of around \$11 billion in tax expenditures.

A third approach, which would reflect the most common treatment of superannuation internationally, whether through defined benefit or defined contribution schemes, is to exempt both contributions and any investment earnings, but to tax in full the income derived in retirement i.e. all withdrawals (‘EET’). This is consistent with the concept of spreading lifetime earnings.

No official estimate is available, but the tax expenditure figure on the basis of the EET benchmark would be less than under the comprehensive income approach, because the average tax rate applying would be somewhat lower (contributions are made when people have substantial earned income, while benefits are received when people have lower if any income other than from their savings, including their superannuation). Currently, given that the compulsory system will not be mature (in the sense that people have been in it for the whole of their working lives) for many years from now, the figure for the tax expenditure relative to an EET benchmark would likely be much lower than the above estimate relative to a TEE benchmark.

There is no right or wrong way of measuring the tax concessions: each one may have validity for different purposes. Superannuation saving is favoured over other forms of saving, but if the underlying purpose is to facilitate the spreading of lifetime earnings, the appropriate benchmark would be EET, as is used in most other advanced countries. This suggests that the budgetary savings from limiting the tax concessions would not be very large, but would still be worthwhile and important for the sustainability of the system overall. However, the significant proviso is that the *quid pro quo* for an EET or equivalent approach would be, as discussed further below, that the savings are genuinely spread over the lifetime and consumed (and taxed) in retirement.

3.3 Robustness

All retirement income systems exist over many decades and will therefore be subject to a range of social, economic and political circumstances; some of which may be predicted (at least to some extent) and others which will be totally unexpected. These can significantly affect the value of the age pension provided by the Government and/or the retirement benefits provided from superannuation.

Some of the possible circumstances that will affect these outcomes include:

- Adverse market returns which reduce the real value of the funded superannuation benefits
- Rapid salary increases, without a corresponding increase in market returns, which reduce the ability of the superannuation system to provide benefits that maintain previous living standards
- High levels of inflation which reduce the real value of superannuation benefits
- Rising life expectancies which increase the number of years in retirement
- Ongoing government budget deficits (which could be caused by a range of factors) which reduce the ability of the government to maintain the value of the age pension
- Rising levels of unemployment which reduce the ability of individuals to save for retirement.

It is therefore apparent that any retirement income system must have an element of flexibility within it so that certain adjustments can be made in response to changing circumstances. However it is also important that these responses are not sudden or of a 'knee-jerk' variety. Rather they should be made within an overall stable framework to deliver retirement incomes to all Australians. Gradual adjustments (such as increasing the preservation age and pension eligibility age) represent examples where good policy has been introduced gradually so that retirement plans of individuals are not suddenly affected.

There are a range of levers that can be gradually adjusted to respond to changing circumstances. These include items such as:

- The age pension eligibility age
- The indexation used for the age pension

- The means tests used for the age pension
- The level of compulsory superannuation contributions made by employers and employees
- The taxation arrangements for superannuation
- The preservation age for superannuation
- The form of benefits that can be taken from superannuation.

The important principle is that adjustments should be announced well in advance and implemented over time, unless there are extreme circumstances. The reason is simple. The provision of retirement income is a long term arrangement over many decades and there must be ongoing community confidence that the overall system will continue, in a broadly similar format, for many years to come. The different reform options also involve tradeoffs between objectives and impacts on different groups. So apart from gradualism, change therefore needs a holistic consideration of all the options.

3.4 Simplicity and Certainty

Risk sharing between the public and private sectors is a strength of Australia's retirement income system in terms of resilience. However, in practice it has significant limitations in terms of complexity.

“Certainty requires that the general concepts and core workings of superannuation are sufficiently clear for an ordinary person to understand. People should have sufficient confidence in the regulatory settings and their evolution to trust their savings to superannuation, including making voluntary contributions” (Charter Group 2013, p 24).

Where superannuation fund members have their superannuation funds placed in a default option, they are not required to make proactive investment decisions in relation to their superannuation.⁷ They must make active decisions on other matters when they retire and/or access their superannuation. In many cases, individuals and households have to deal with either or both the superannuation and the pension systems, as well as the tax system, and all the complications associated with the interactions among these.

The removal of tax on benefits for people over 60 years has served to simplify arrangements in some respects but has complicated them in others. Further complexity is added to the system by the targeting of concessions, including via the application of caps on concessional contributions, thresholds for contributions and work tests for the over 65s. It has also greatly complicated the transition of members from the accumulation phase to the post retirement phase – both from the individual member's perspective and from the fund/product supplier perspective.

As the Henry Review (2009) correctly noted, the additional burden caused by complexity is likely to be highly regressive. People with fewer resources, and often

⁷ This emphasizes the importance of the overall efficiency of the system, cost of distribution, super account costs & optimum design of default options.

lower financial literacy, will have greater difficulty in coping with complexity thereby magnifying the problem. Simplicity in arrangements is therefore an important principle in system design.

An important factor in 'certainty' is to have consistency in policy settings given the long time frames of retirement income decisions. This was recognised as an issue as far back as 1993 in the FitzGerald report on national saving:

“It goes almost without saying that further change to superannuation is not desirable in itself — continual change in recent years has engendered complexity and uncertainty and diminished confidence. But if change is highly desirable in the long term, it is better done sooner than later. The aim is to move quickly to a superannuation system that has the 'essentials' right, supports national saving objectives, and can justify community trust in its long-term durability.” (FitzGerald 1993, p 58)

It needs to be recognized though that the system also needs to adapt over time to changing circumstances and to improve. More particularly:

“People should feel confident that the broad direction of superannuation policy is clearly understood and stable, and that any changes will be consistent with that direction.” (Charter Group 2013, p 25)

Therefore, rather than no change at all, what is more important is to avoid the risk of instability because of inconsistent policy settings.

3.5 Sustainability

The sustainability of any form of government subsidy (whether as an expenditure or as a tax concession) is difficult to assess without also considering the other pressures on the government budget, and relative priorities. 'Sustainability' also relates to more than financial sustainability – it also concerns continuing community support for the policy framework that therefore must be coherent and provide certainty (as discussed above).

Forward projections based on current arrangements suggest that total government outlays will fall from 25.0% of GDP in 2014-5 to 23% in 20 years before rising again to 25.1% 20 years later (Intergenerational Report 2015). Aged and service pension expenditure was projected (before the most recent assets test change) to rise as a share of GDP over the next 40 years from 2.9% to 3.6% although this will remain low by OECD standards.⁸ Health expenditure is projected to increase considerably from 4.2% to 5.7% under current arrangements (IGR 2015). Aged Care expenditure is also expected to rise, from 0.9% to 1.7% (IGR 2015). Tax expenditures are also projected to increase from over \$30 billion to almost \$50 billion by 2021-22 under a continuation of present policies.

⁸ They were projected to decline slightly to 2.7% under the Government's then proposed policies that have not been agreed by the Parliament (IGR 2015, pp 69, 100). The proposed measure to index the age pension to the CPI which would have had a negative long-term impact on adequacy for poverty alleviation purposes, was subsequently withdrawn by the Government (Coorey 2015, p 2). The impact of the recent assets test change has yet to be modelled but seems likely to reduce the growth by 0.1 or 0.2 percentage points ie to 3.4 or 3.5% of GDP.

Of course, it may be that society will consider that these extra expenditures should be covered by other savings elsewhere in the budget or by additional revenue raising efforts. Any such alternative may, however, depend upon society being convinced that the distribution of the benefits are fair and all efforts have been made to remove waste and increase program effectiveness so that there is no alternative to increasing taxation if the various government services and forms of assistance are to be maintained. In these circumstances, governments will be under pressure to examine the cost of the retirement income system to see if some savings are possible to reduce the contribution to fiscal pressure from this source.

Sustainability also encompasses the need for community support for superannuation. Support for superannuation is necessary for any policy to be successfully implemented. A survey administered by the industry found that there was a high level of community support for superannuation (86%) (FSC 2014). Despite this, 53% of those surveyed do not “feel informed enough to make decisions” (FSC 2014) and 65 % indicated that “there are too many changes to the superannuation system” (FSC 2014). This suggests a layer of disconnect from members and their superannuation, perhaps due to the level of complexity in the system and frequency of changes.

4. Weaknesses of the Current System

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

4.1 Safety Net

4.1.1 Adequacy of the Age Pension

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

Private renters receive significantly lower levels of assistance than those in public housing and face much higher housing costs than the majority of aged people who own their own homes and have limited, if any, mortgages to finance. The vast majority of pensioner couples are homeowners, while only one in two singles is a home owner.⁹ The Henry Review (2009) noted that there is a strong case for aligning rental assistance and public housing subsidies.

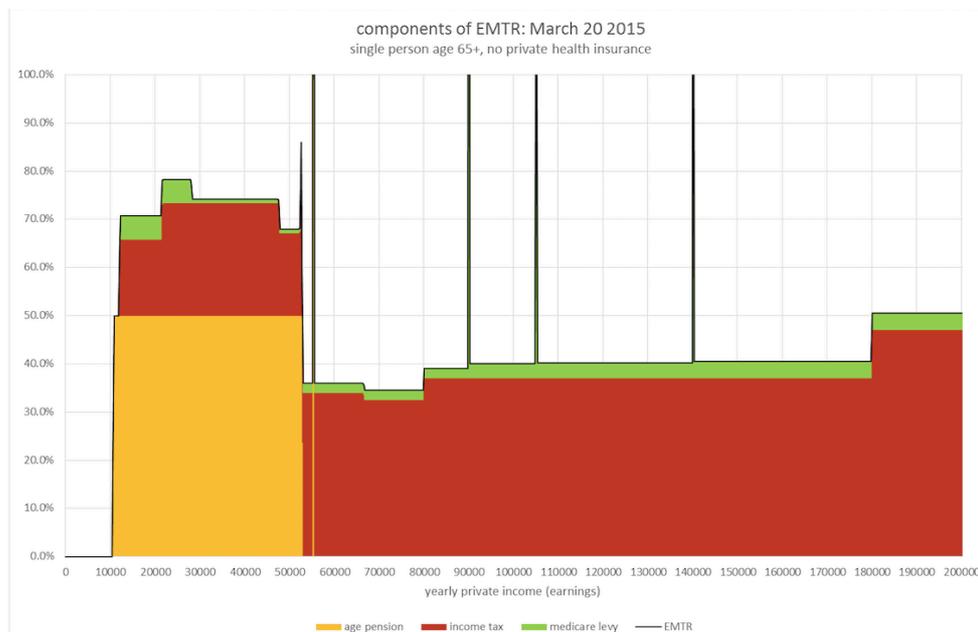
⁹ 82.9 per cent of Age Pensioner couples and 53.4 per cent of singles are homeowners or purchasers” (DSS 2008, p 52).

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

4.1.2 Problems with incentives to work and save

Another matter of potential concern is the impact of the targeting of the age pension through means testing arrangements on incentives to work and save, and possibly on the types of saving and assets held. While target efficiency is achieved by the withdrawal of pensions as pensioners’ own-income and assets increase, inevitably this withdrawal gives rise to high effective tax rates. Chart 4 shows that single retirees face very high EMTRs where they earn between \$10,000 and \$50,000 in annual income, but that EMTRs are more moderate at higher income levels. On the whole, however, the evidence suggests that high effective marginal tax rates are not as significant a problem for age pensioners as for other classes of recipients of social security payments.

Chart 4: Effective marginal tax rates



Source: Plunkett (2015).

For the social security system as a whole, the highest EMTRs are typically experienced by households with dependent children, and most age pensioners do

not have dependent children.¹⁰ The picture for the aged is made more complicated by the different tax treatment of super savings and earned income, such that EMTRs on untaxed superannuation income are generally around 50 per cent (though deeming and assets test arrangements complicates this further) and between 60 and 65 per cent for earned income (which is taxed).

Anecdotally, disincentives to work and save may potentially be exacerbated by linking additional in-kind benefits (including through the seniors' pensioner health card) to pension eligibility. But usually these supplementary benefits are not subject to separate means tests and, when they are, the EMTR phase-out range for these in-kind benefits is often quite narrow. For those pensioners potentially caught within this phase-out range there is an incentive to re-arrange their assets to avoid having an income in the relevant range by or making fairly minor adjustments to their working hours.

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

Over the thirty years between the early 1970s and the early 2000s, total male workforce participation dropped by around 12 percentage points and has not significantly recovered since. The fall in male employment participation was especially large (15 percentage points) for men aged between 55 and 60. Most importantly almost all the big fall in male participation for those aged 25 -54 was accounted for by the fall in participation by those males who left school early and have no further qualifications (Kennedy and Hedley 2003).

The consequence now is that for those mature-aged workers aged 45-59 and approaching their retirement there is a twenty percentage point difference in the employment participation rates for those who completed year 12 and/or with post-school qualifications and those who left school early with no further qualifications (see Chart 5 below).

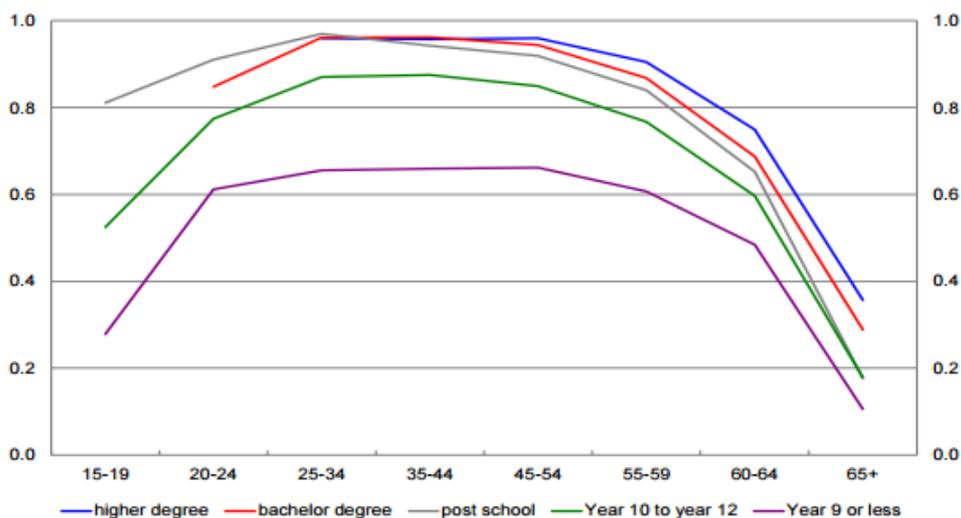
Furthermore, this gap in participation between those who have received more education and those who have not is even more significant for females (Table 1). This evidence suggests that lack of educational attainment is likely to play a more significant role in preventing people from working longer than do EMTRs.

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

¹⁰ In 2002-03, 12.8% of households headed by a person aged 65-69 had dependent children (AMP/NATSEM 2004).

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

Chart 5: Male participation rates by education and age



Source: 2011 Census of Population and Housing

Source: Gruen (2014, p 7).

Table 1: Employment participation rate of selected mature-age (aged 45-59) cohorts by sex, 2011

Did not complete Year 12 & no post-school qualifications			Completed Year 12 and have post-school qualifications		
Male	Female	Persons	Male	Female	Persons
71.3%	59.7%	64.5%	88.8%	81.6%	85.2%

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

retirement. Deeming income from the assets including drawdown of the capital would likely involve effectively halving the new assets test withdrawal rate, but applying this from lower levels of assets, offering a better balance of incentives to save and pressure to draw down savings over retirement years.

4.1.3 Age pension and preservation ages

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

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

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

In addition, some people (particularly women) contribute to society via non-paid work such as caring for the very old. The balance between work and 'leisure' as living standards improve should be debated more widely before the age pension age is increased further.

A further consideration is that the age pension age is currently higher than the preservation age allowing scope to dissipate retirement savings before reaching age pension age.

The preservation age – the earliest age at which benefits may be taken from accumulated savings – affects how well the system supports genuine retirement income and consumption. From 1 July 2015, the preservation age is 56 (rising to 60 in 2024) while the age pension age is 65 and will increase to 67. There is some risk of savings being taken via lump sums before age pension age, adding to reliance on the pension, though so far this has not presented a serious problem (PC 2015). For those genuinely retired or in transition to retirement, some access before the pensionable age to their own accumulated savings (perhaps up to a certain limit) may be considered reasonable and consistent with the purpose of spreading lifetime incomes and facilitating transition to retirement.

4.1.4 Improving the efficiency of the safety net

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

The exemption of the family home in the pension means test provides an important element of security in retirement but is inconsistent with targeting to those with the greatest need. Homeowners face lower housing costs, have a substantially higher net worth, and on average have more non-housing assets than those who don't own their own homes. They therefore have greater ability to support themselves than non-homeowners. The new pension assets test attempts to take this into account through the higher thresholds for non home-owners but, for those with few assets, pension entitlements are very similar for home owners and non home-owners.

While the family home has been exempt from the means test almost since the age pension was introduced, the case for full exemption is becoming weaker as home assets and other assets are growing. As the superannuation system matures, there is a strong case to include the value of the home above some threshold (possibly decreasing over time). The impact on incomes and consumption could be ameliorated by allowing the age pension to continue to be paid and recovered later from the estate. In keeping with the principle that major changes should be announced well in advance and implemented over time, any such change should be phased in gradually, for example so that no-one over the 55 years would need to alter their present retirement plans.

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

4.2 Superannuation Contributions

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

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

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

For middle income earners and above, the mandated level of contribution is currently too low for many to maintain living standards in and through retirement; however this is often made up for by voluntary contributions (and other saving), or people decide that they do not require replacement to that percentage level to live comfortably. Table 2 shows estimates of contribution rates by remuneration in 2009-10 when the compulsory employer contribution rate was 9%, revealing much higher rates in practice for those with incomes between \$100,000 and \$300,000.

On the other hand, the current mandated level of contribution is higher than needed for low-income earners to maintain their living standards in retirement, given the availability of at least a part age pension. It may also impose a constraint on liquidity for some in this income cohort at times in their lives when they face other significant priorities (e.g. housing, education, training, and child rearing).

The replacement rate outcomes arising from the superannuation guarantee and voluntary saving are strongly linked to workforce participation. Work patterns vary markedly due to gender, skills, individual work preferences and opportunities, and migration. Groups with more varied work participation, such as women, tend to experience lower, and in many cases, deficient retirement incomes, particularly those who live on their own and so do not share incomes or expenses.

The required contribution rate to achieve a certain replacement rate varies by income cohort and by pattern of involvement in work over a lifetime. This suggests that increasing the mandated rate for compulsory superannuation would have a greater negative impact on low-income earners. On the other hand, those people on higher incomes who want to maintain their higher living standards in retirement can do so by placing greater reliance on voluntary savings, and have greater opportunities to 'catch up' later if they have had career breaks. In summary, a flat compulsory contribution rate across all income cohorts and work patterns has limitations given that different groups vary in their capacity to save at different stages of their adult lifetimes.

There is the concern that, in cases where superannuation is not compulsory (i.e. for low wage earners and those over 70), such employees may not be receiving an equivalent amount in their income. The \$450 per month threshold for SGC contributions has been in place since the SGC was introduced and has never been adjusted. Because an employer is relieved of a 9.5% on-cost where pay is below the threshold, it acts as a cap on the earnings of part-time and casual workers. These employees do not receive superannuation contributions and do not receive the benefit of an equivalent amount in their pay. The \$450 threshold also does not recognise that many part-time and casual employees work more than one job.

Table 2: Contribution rates by annual remuneration

Annual remuneration^(b)	Average annual contribution (\$)	Average contribution rate (% of remuneration)	Proportion of people making a contribution above \$25,000 (%)
\$20,000 and under	1,048	10.4	0.2
\$20,001-\$40,000	2,342	7.7	0.1
\$40,001-\$60,000	4,121	8.4	0.6
\$60,001-\$80,000	6,435	9.2	2.1
\$80,001-\$100,000	9,504	10.7	5.4
\$100,001-\$120,000	13,285	12.2	11.3
\$120,001-\$140,000	17,393	13.5	16.7
\$140,001-\$160,000	22,372	15.0	23.5
\$160,001-\$180,000	27,929	16.5	30.8
\$180,001-\$200,000	27,111	14.3	29.9
\$200,001-\$300,000	31,263	13.2	37.7
\$300,001-\$400,000	35,488	10.3	48.3
\$400,001-\$500,000	40,192	9.1	55.6
\$500,001 and over	46,347	4.4	64.1

(a) Treasury projections for 2009-10. Projections are based on 2005-06 data. Contributions in subsequent years were impacted by policy changes and are a less reliable basis for projecting contributions in 2009-10. Projections are adjusted for significant policy changes since 2005-06 (the introduction of the \$50,000 concessional contributions cap and \$100,000 transitional cap) and for changes in wages and population. The table includes both employees (and the superannuation guarantee and salary sacrifice contributions made by their employer) and the self-employed (who can make deductible contributions).

(b) Remuneration is taxable income plus salary sacrificed amounts plus fringe benefits. The average contribution rate can be below 9 %, as the definition of remuneration used in the table is different to the income base used to calculate the superannuation guarantee and the table includes people who are not covered by the superannuation guarantee.

(c) based on a comprehensive income tax benchmark.

Source: Henry Review (2009) based on Treasury estimates.

4.3 Superannuation Tax Arrangements

In retirement income taxation, as mentioned earlier, there are strong theoretical arguments in favour of expenditure tax treatment – involving exempting contributions and earnings from tax and applying full marginal tax rates to withdrawals at the benefit stage (referred to as 'EET'). This has merit in terms of spreading lifetime earnings and providing a motivation to continue working into retirement. It also has the budgetary advantage of timing revenue receipts to coincide with population ageing. However, Australia has now entrenched a very different approach – a variant

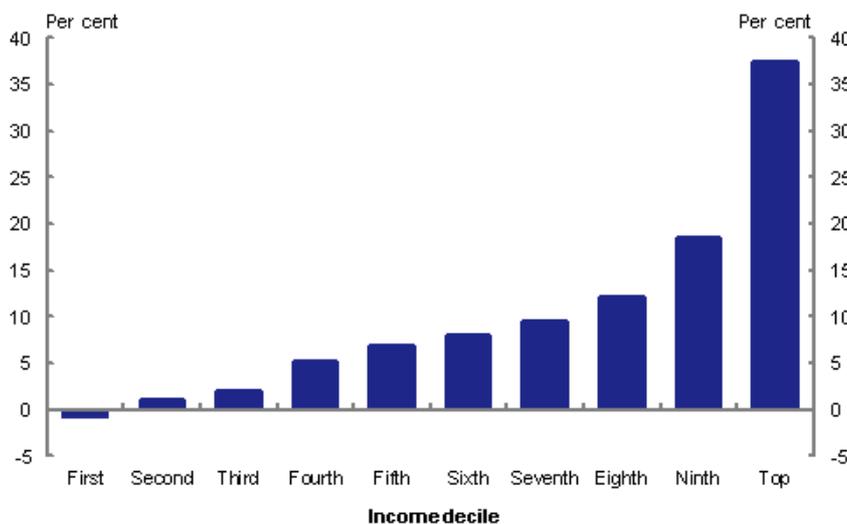
of the comprehensive income tax (TTE) framework involving concessional tax rates on contributions and earnings during the accumulation phase, and no tax on benefits or on earnings in superannuation pension accounts (ie a tE approach).

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

On the other hand, for low-income earners on the lowest tax rate who do not receive income support, the 15% contributions and earnings tax provides little if any concession. For those below the tax threshold, there is a tax penalty.¹¹

Using a comprehensive income tax benchmark to cost superannuation tax concessions highlights the skewed distribution of the concessions by income decile. Using this basis, as shown in Chart 6, the majority of tax concessions accrue to the top 20% of income earners. The total tax expenditure is lower using other benchmarks, although the distribution towards higher income groups remains.

Chart 6: Share of total superannuation tax concessions by income decile

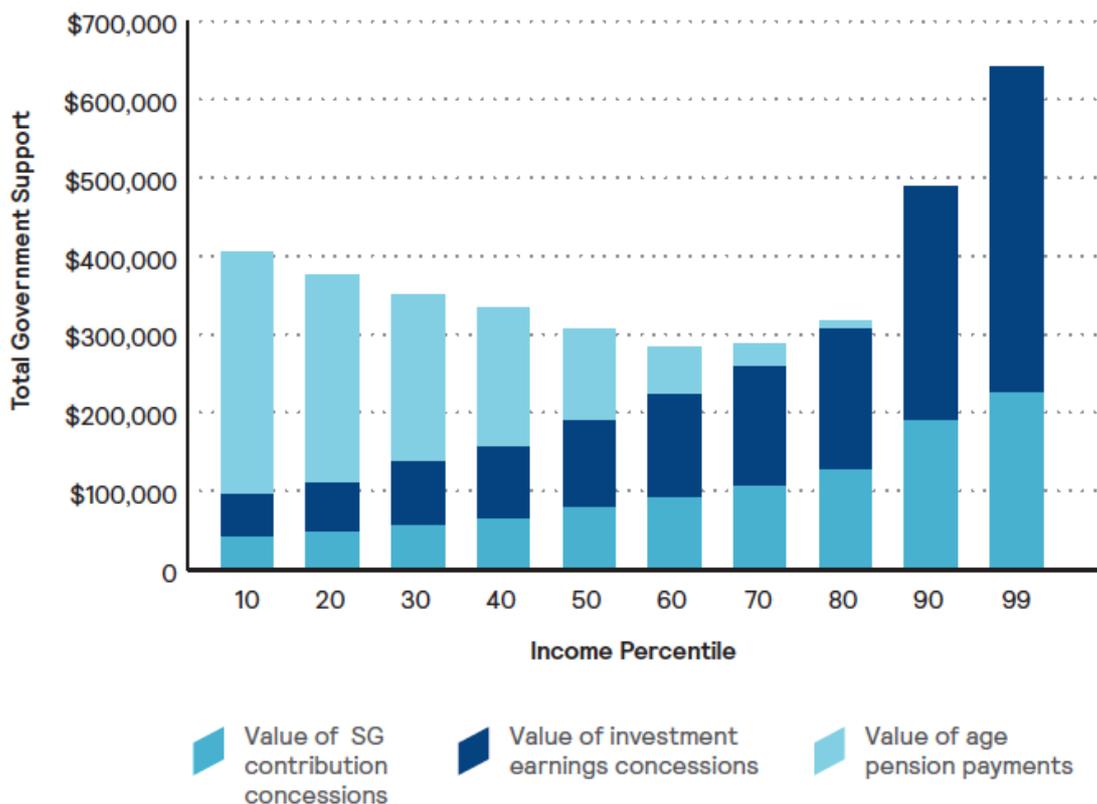


Source: Treasury, based on an analysis of 2011-12 Australian Taxation Office data.

¹¹ Low income earners previously received a low income super contribution, which has now been phased out.

A more complete account of government support is provided by combining superannuation taxation concessions and the age pension. Clearly, if superannuation tax concessions were to be reduced or removed, it would likely lead to lower superannuation savings and possibly an increase in future age pension costs. Chart 7 from AIST/Mercer indicates the level of total support across a lifetime at 10 income levels (based broadly on the TTE tax benchmark). It shows that total income support from the government initially decreases as income rises; however at higher incomes, the total cost increases. While Rice Warner (2015) uses a different methodology, they find a similar skewing of support at very high income levels. Overall the distribution of government income support to assist people in their retirement is not progressive, and it actually favours the highest income decile.

Chart 7: Combined superannuation tax concessions and pension payments by income decile (tax concessions based on Treasury’s comprehensive income tax benchmark)



Source: AIST/Mercer 2015

The question this raises is where should the line be drawn when assessing the distributional consequences of retirement incomes policies. Is it a problem if individual components of government support (particularly superannuation tax concessions) are not particularly or at all progressive so long as government support overall is progressive? In general terms, it is our contention that the design of the

retirement income system should be consistent with the articulation of the objective of maintaining adequate incomes throughout the years of retirement. Fiscal sustainability implies targeting the distribution of government assistance to those in greatest need.

In summary, current superannuation arrangements involve both compulsion and incentives: an increasing percentage of the earnings (currently 9.5%) of most employees must be in the form of superannuation contributions, and superannuation savings are treated more generously for taxation purposes than other savings and other forms of remuneration. The system is achieving improved retirement incomes but the cost in terms of revenue forgone is significant and the benefits of the incentives are skewed strongly towards higher income groups.

4.4 Post Retirement Arrangements

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

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

The main ways superannuation savings are used to support retirement are phased withdrawal products and lump sum withdrawals to reduce or repay the mortgage on the family home. The proportions of estimated retirement benefits taken as income streams for 2013-14 are summarised in Table 3 according to both assets (funds under management) and the number of member accounts. Lump sums can be further disaggregated into full and partial lump sums. In this year, only 9 per cent of *assets* were taken as full lump sums, 7 per cent as partial lump sums and the remaining 83 per cent was rolled over to an account-based pension. However, 34 per cent of *accounts* were taken as full lump sums, 25 per cent as partial lump sums and 41% as an account based pension, indicating those members taking full lump sums generally have low balances.

The data also shows that only 28 per cent of accounts with balances of \$50,000 or less are taken as pension rollovers. However, for balances between \$50,000 and \$100,000, the split between accounts taken as lump sums and those taken as pensions is roughly even. Most notably, for balances of more than \$300,000, almost 87 per cent of accounts are taken as allocated pensions (Rice Warner 2015). Similar results were obtained by Rothman and Wang (2013) (Table 4). Of the people who opt for lump sums, Australian Bureau of Statistics data (2013) suggests one quarter

invest in their own home, 18 per cent reinvest as ordinary money and 13 per cent reinvest into another retirement scheme (Rice Warner 2015).

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

Table 3: Retirement rollovers and benefits payments – estimated split.

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

Source: Rice Warner (2015). Derived from Rice Warner's analysis of a dataset comprising information from more than 10 million member records representing more than \$55 billion in assets for 2013-14.

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

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

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

individuals pursue their interests through their consumption choices based on a reasonably stable and reliable income stream.

The amount received at retirement under account-based pensions and similar approaches, *ceteris paribus*, may be variable especially during periods of investment market volatility. Buying a long-term annuity increases the risk of market timing at the time of retirement (Rice Warner 2011). While many members have little control over the timing of their retirement, they can adjust their investment strategies to prepare for the uncertainty of investment markets at the point of retirement.

Table 4: Retired persons, lump sum payments and superannuation income by gross weekly income (percentage of those with a superannuation benefit)

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

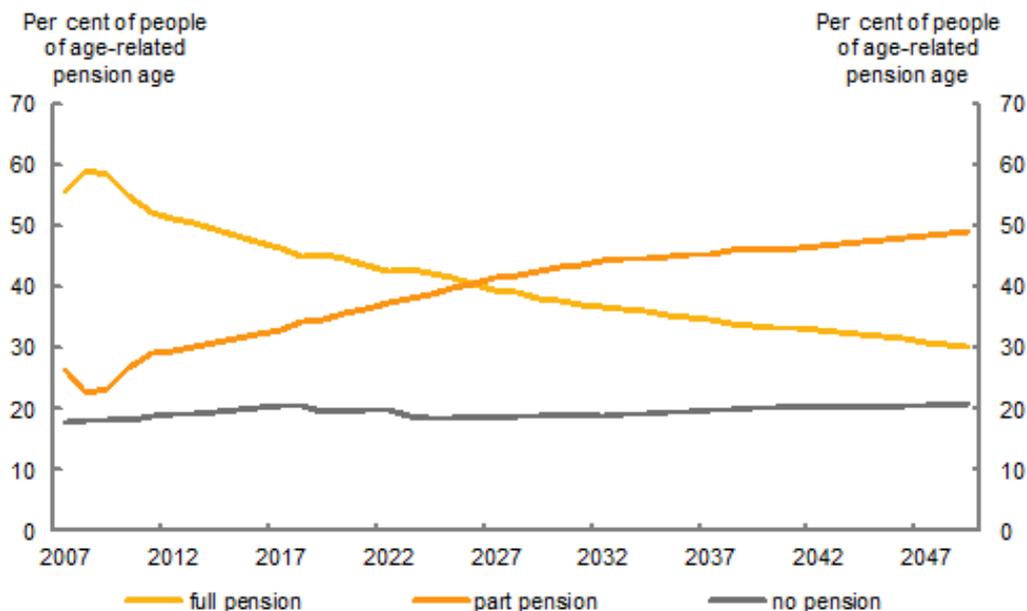
Source: Rothman and Wang (2013, p 8).

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

4.5 Interaction between Superannuation and Age Pension Systems

Age and Service Pension payments are currently equal to 2.9% of GDP and, prior to the recent assets test change, were projected to continue rising, reaching 3.6% of GDP by 2054-55 (IGR 2015). In today's dollars, spending per person was projected to increase from almost \$2,000 in 2014-15 to around \$3,200 in 2054-55 due to current indexation arrangements. This increase was projected despite the fact that the underlying composition of the pensioner population is changing. Largely as a consequence of the maturing of the superannuation system, the proportion of full rate pensioners was projected to decline from 50% today to 30% in 2050 while the proportion of part rate pensioners was expected to increase from 30% to 50% over the same period. The ratio of pensioners to the total retiree population however may remain largely unchanged, as depicted in Chart 9 (Cooper Review 2009, IGR 2015).

Chart 9: Proportion of people of eligible age receiving full, part or no age or service pension



Source: Cooper Review (2009) based upon Treasury's RIMGROUP model (raw data not publicly available) and Rothman (2012).

The Financial System Inquiry Report suggests that the purpose of superannuation is *"to provide income in retirement to substitute or supplement the Age Pension"*. Superannuation appears to be *supplementing* age pension income as indicated by the growth of part rate pensioners relative to full rate pensioners, and in so doing is contributing to a reduction in pension outlays compared with what they would otherwise be. However, on current policy settings, superannuation is not expected to

do much to *substitute* for the pension as the ratio of pensioners to the total retiree population is expected to remain flat for many years to come¹².

This raises the question whether superannuation should do more to *substitute* for the age pension and what it would take for such substitution to occur? A couple of facts bear on these questions. First, the pension cut-off point is defined by the level of the pension and the income and assets test tapers. With the combined married rate at over 40% AWOTE and a 50% taper above an income threshold, the pension cut-off point for married people is close to 100% AWE; for singles it is around 60% AWE.

¹³Second, a 12% superannuation contribution rate for a person on average earnings over a 30-year working life results in annual retirement income at the ASFA comfortable standard (\$43,000 for a single) falling just short of the pension cut-off.

The vast majority earn considerably less than average earnings over their years of working age partly because of interrupted earnings and employee casualisation. In addition of course the average is higher than the median so 80 per cent of full-time employees earn less than the average at any point in time. Moreover, it will also be many years before a large proportion of the retiree population has been through the superannuation system with average annual contributions over the working age range approaching anywhere near 9%. The corollary is that even when the retirement income system reaches full maturity most retirees will be eligible for and will need a part age pension if they are to achieve a comfortable living standard.

Some further reduction in the proportion of retired people in receipt of some age pension may be achieved by rational if highly controversial reforms such as including the family home in the means test above a high threshold and increasing the preservation age to increase superannuation savings, but more substantial reductions would require policies that are likely to have adverse implications for incentives and/or to affect very large numbers of home-owners. The new assets test already involves questionable incentive impacts.

This suggests that the main source of savings in pension outlays will come from the shift from full-rate pensioners to part-rate pensioners. In any case, policy changes should not be driven solely by budgetary considerations of course, but rather should be considered in the context of the broader design of the system to meet its overarching objectives. This reinforces the importance of specifying and agreeing the objectives of the retirement income system.

5. Directions for Reform

Reform of the retirement income system is needed to better address the weaknesses identified above and the following factors:

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

¹² It is understood that the RIM model used by Treasury and the Cooper Review fixes the coverage at 80%, and does not in fact project how coverage may change. DSS data reveal some reduction in coverage in recent years and further reduction can be expected consistent with the impact of increasing superannuation savings on the proportions receiving full and part-rate pensions.

¹³ The assets test also applies and is likely to be more stringent.

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

The following section canvasses for discussion a range of reform options that might be considered as part of a comprehensive review of the system. Several represent alternatives and, in addition, many would need considerable work to refine and implement and a number would require lengthy phasing in arrangements.

An illustrative package of reforms is presented at the end of this section to show how a coherent and comprehensive approach to reform might be developed and negotiated with stakeholders and debated amongst the public.

5.1 Safety Net

Improving the efficiency and adequacy of the safety net by:

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

Tightening the means testing by:

3. Reviewing the deeming rates for superannuation savings on the assumption that the capital should be drawn down over lifetimes.
4. Improving the targeting of the age pension to those with the greatest need by including the deemed value of owner-occupied housing (beyond some threshold) in the means test while deferring the impact on the age pension by treating it as a contingent liability against the estate. This could be phased in over time as the superannuation system matures and so that no-one over the age of say 55 would need to alter their present retirement plans.
5. Unlocking an income stream from home equity by legislating for a default reverse mortgage product although the complexities associated with this option need to be recognized.

Encouraging aged employment participation by:

6. Introducing employment-training programs targeted at improving the skills and adaptive capacity of those workers with low education and qualifications and who have low participation even before they retire.
7. Incentivising people to work longer through easing the means test on earned income by relaxing the withdrawal rate on earned income (e.g. going back to the 40% introduced with the GST). The implications for distributional fairness would need to be investigated.

Reforming the age pension and preservation ages: It is important to recognize there is no 'perfect' age pension age as there will always be people who need help and can't work prior to achieving whatever age is chosen. Although with rising skill levels and in a services-based economy, over time more workers will be able to work longer. Options for consideration include:

8. To remove the pension age from the political arena by linking it to trend growth in longevity but only after the impact of the currently legislated pension age increases have been fully assessed.
9. Applying some level of tax on any benefits in excess of some threshold taken before age pension age. The setting of a threshold would help to overcome equity issues for low income earners who would need to call on such access.
10. Raising the superannuation preservation age to equal the pension age or fixing the gap between the two at (say) 5 years.

5.2 Superannuation

In setting the mandated contribution level, needs in terms of retirement incomes must be balanced with needs at other stages of lifecycle. This might suggest the following options:

11. Limiting any further increase in the mandated employer contribution to 10%;
12. Limiting any increase to 12%.

Allowing flexibility for people to set their contribution levels below the mandated amount in specified personal circumstances, perhaps subject to them subsequently making up the difference in their contribution rate, is another option but it would raise significant administration hurdles and would increase the system's complexity.

For people with interrupted careers, an option is to increase the annual contribution caps. This would make it easier for people with interrupted careers to make up for nil contributions in earlier years with higher contributions in later years. On the other hand, only a minority of people can afford to contribute at or above the annual caps, and people with low or modest lifetime earnings (including a majority of women) would benefit more from reducing the tax on contributions.

Alternative options are:

13. Allowing people to have higher caps in recognition of specified years spent out of the paid workforce with no contributions made;
14. Retaining separate caps for non-concessional contributions.

The last option would provide an opportunity not only for people with interrupted careers to 'catch up' superannuation savings but also for those who spend time overseas without access to Australia's superannuation system to do likewise. It would not involve excessive costs to revenue so long as the savings are directed to genuine retirement income, though some cap commensurable with the concessional cap might be advisable.

Consideration could also be given to:

15. Broadening the coverage of the mandated contribution, by reducing or removing the \$450 per month threshold and extending the mandate to self-employed people.

5.3 Superannuation Tax

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

Switching from ttE to EET or TET would require complex transitional arrangements over 40 years or more if existing superannuation savings from previously taxed contributions and earnings were to be exempt, and a severe loss of government revenue during this long transition period.

Alternative incremental changes might be considered which promote the spreading of lifetime incomes to support genuine retirement income purposes and close off opportunities for high-income earners to gain disproportionately from the tax concessions. Possible approaches include the following:

16. The Henry Review proposals involving applying a progressive tax on contributions based on individuals' marginal tax rates less a rebate of 20% (including or excluding a negative tax at low incomes), and equalising the earnings tax rate between the accumulation and post-retirement phases by applying a standard 7.5% tax on fund earnings in both the accumulation and post-retirement phases.
17. Applying the 30 per cent tax on contributions from incomes above \$180,000 rather than \$300,000, removing the tax where income is below \$37,000 (where the marginal rate of income tax is 19 per cent or lower) and applying a tax on fund earnings in the post-retirement phase. (This option would broadly apply the Henry Report approach to the current income tax scale.)
18. Reduce the non-concessional contribution caps to (say) equal the concessional contribution cap levels.

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

Early access to superannuation could be limited so as to provide an increased retirement income (with consequent age pension savings) by increasing the preservation age. Options include:

19. Increasing the preservation age to 62, retaining the five-year gap with the age pension age.
20. Aligning the preservation age and the age pension age.
21. Limiting the amount of superannuation that can be taken as a lump sum, and/or before pensionable age.

22. Exempting people unable to engage in paid work due to disability or caring roles from an increase in the preservation age, and taking into account much lower life expectancy amongst Aboriginal and Torres Strait Islander peoples.

5.4 Post Retirement System

In making recommendations relating to the post retirement phase, the FSI Panel considered and rejected both a mandate and a default post retirement solution given their significant downsides. Its recommendation of a Comprehensive Income Product for Retirement (CIPR) offers the potential to achieve some of the core benefits of mandate and defaults while reducing many of the significant downsides.

In particular, the benefits that the CIPR shares with both default and mandatory annuitisation include:

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

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

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

On the other hand, the fact that a CIPR is “modular” could invite a lot of options and choices that may be difficult for consumers to understand and may make them vulnerable to poor sales practices. This problem is magnified by the fact that annuities are excluded from recent changes to strengthen safeguards in relation to financial advice.

While the concept of the CIPR has some merit, its ability to deliver improved retirement outcomes will depend largely on how it is implemented and received. Unless widely adopted by retirees, the products could still suffer from adverse selection and fiduciary requirements that add to costs, and leave people more reliant on the age pension than is really necessary. Potential CIPRs should be assessed according to a number of criteria including:

- Their ability to trade off the various risks (investment, inflation, longevity) that retirees will face through retirement. While products such as annuities may cover longevity risk, the individual may instead face risks related to liquidity or timing of purchase.
- Their ability to deliver consumption smoothing between working life and retirement dynamically tailored to phases of retirement so that products will be appropriate for a greater proportion of people and the changing circumstances that they face moving through retirement. For example, individuals in early retirement tend to be more concerned with balancing growth and liquidity, while in later retirement longevity risk becomes prominent.
- The extent to which individuals do indeed take up the products.

Consideration should also be given to options to improve the capacity of the market to manage longevity risk including through longevity bonds (instruments related to risks about projected mortality rates, akin to indexed bonds that allow the risk of inflation to be traded).

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

5.5 Illustrative Reform Package

Lasting reform will require lengthy and informed public debate and negotiation amongst stakeholders. A coherent, holistic approach that addresses the core objective and meets the principles set out earlier in this submission will require a package of reforms that balance a range of competing considerations.

The following package is presented, not as a recommendation, but as an illustration of an approach that would significantly improve the effectiveness, efficiency and sustainability of the retirement incomes system. Many elements would need careful development and the overall impact would need modelling to clarify winners and losers and the likely overall economic and budgetary effect.

5.5.1 Safety Net

- A common indexation factor for all social security pensions and allowances, less generous than the current pensions index but more generous than the current Newstart index, with automatic CPI indexation and independently determined adjustments in line with changes in community incomes every two or three years.
- Merging the income and assets test, applying deeming rates that assume assets (particularly superannuation savings) will be drawn down over people's retirement years.

- Phasing in the inclusion of the value of the home in the means test above a high threshold, with provision to retain security of tenure without losing access to the pension subject to eventual repayment of any pension debt from the estate.
- Using some of the savings to fund increases in rent assistance.

5.5.2 Retirement Age

- Phasing in further increases in the preservation age to 62, and reviewing the age pension age in the light of experience some time after it has reached 67.
- Increased support for employment training for older people with low education and qualifications
- Increasing Newstart, particularly for those aged over 60 who have been unemployed for more than three years (or introducing a Transition to Retirement payment equal to the pension for this targeted group).
- Allowing exceptions to the preservation age for such people and for those undertaking unpaid caring duties.

5.5.3 Superannuation

- Containing future increases in the mandated employer contribution to 10 per cent.
- Broadening the coverage of the mandated contribution by reducing the \$450 per month threshold to, say, \$200.

5.5.4 Superannuation Tax

- Applying a 30 per cent tax on contributions where income is over \$180,000, retaining the 15 per cent where income is between \$37,000 and \$180,000 and removing the tax where income is below \$37,000 (broadly similar to Henry but applied to the existing income tax scale).
- Phasing in reductions in the tax on earnings in the accumulation phase to 7.5% and applying this rate to earnings in the pensions phase.
- Retaining the current annual caps on concessional contributions, allowing increases for those with specified years out of the paid workforce where no contributions were made and retaining the current caps on non-concessional contributions.

5.5.5 Post Retirement

- Applying limits to the amounts that can be taken before age pension age.
- Retaining minimum drawdown rates in the pension phase.
- Implementing the FSI recommendation to require funds to offer comprehensive retirement income products that include insurance for longevity risk.
- Reviewing the success of this after 5 years' operation to see whether firmer pressure is needed to promote such products and whether longevity bonds or

similar instruments are needed to help the market to trade in longevity risk efficiently.

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

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

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

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