Australia’s future tax system
Retirement income
Consultation paper

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The Treasury
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Dear Dr Henry

I am writing to request the review into Australia's future tax system bring forward its consideration of the retirement income system and report to the Government by the end of March 2009.

The Government wishes to examine the findings of Dr Harmer's review of pensions in conjunction with your Panel's review of the other aspects of the retirement income system. This will allow the Government to consider a broader and complementary response to the issues facing the retirement income system than those issues being considered by Dr Harmer.

In your report, I request that the Panel include recommendations on the adequacy of the retirement income system and the appropriateness of the current taxation arrangements.

Yours sincerely

WAYNE SWAN

Notes

(a) Figures in tables and generally in the text have been rounded.

(b) The term 'Australian Government' is used when referring to the current government and the decisions and activities made by the Government on behalf of the Commonwealth of Australia.

(c) The term 'Australian government' is used when referring to a past government or governments and the decisions and activities made by past governments on behalf of the Commonwealth of Australia.

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Executive summary

Australia has a three pillar retirement income system:

- a government-provided Age Pension;
- compulsory savings enforced through the superannuation guarantee (SG); and
- voluntary savings (both through superannuation and other sources).

The Age Pension provides a guaranteed income based on means, while the income generated from the second and third pillars depends on the amount invested and returns on these investments.

The retirement income system has developed over time. The SG pillar will not mature until 2037 when employees retire after a full working life (35 years) of compulsory superannuation contributions of 9 per cent.

Submissions to the Panel support the structure of the retirement income system. Common themes in the submissions dealt with the current rate of the SG and the level of concessions provided to encourage additional saving. Other themes relate to how the system should deal with individuals outliving their savings and how the system treats individuals with different circumstances.

Key considerations about the retirement income system are whether it is broad and adequate, acceptable, robust, simple and approachable, and sustainable.

Consultation questions

The following questions are posed to stimulate community input to the Panel's consideration of issues relating to retirement incomes.

The retirement income system

Q1.1 In considering the future of Australia's retirement income system, which objectives are relevant in setting retirement income policy? Does the current system of the Age Pension and compulsory and voluntary savings meet these objectives? If not, how should the system be changed to meet these objectives?

A broad and adequate retirement income system

Q2.1 As the SG system matures, it will become a greater part of an employee's retirement income. What are the implications for individuals partially or fully excluded from the mature SG system (the self-employed, individuals with broken work patterns such as carers, women and migrants), and how can the retirement income system best accommodate these groups?

Q2.2 Noting that the adequacy of the Age Pension is being considered by the Pension Review, what is an appropriate concept of adequacy for the retirement income system? Should it be to ensure there is a minimum level of income in retirement, to replace a proportion of income earned prior to retirement, or some other alternative?

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Q5.1 In what ways does the retirement income system impose undue complexity and cost on retirees and workers? How could this complexity be reduced?

A sustainable retirement income system

Q6.1 The Age Pension serves two roles, as a safety-net for individuals who are unable to sufficiently save for their retirement and as an income supplement for many individuals who do save. What should be the role for the Age Pension and means testing in a future retirement income system and what impact does this have on its sustainability into the future?

Q6.2 In what ways does retirement income policy affect workforce participation decisions and what, if any, changes might reduce disincentives to work? Does the sustainability and cost of the retirement income system affect the workforce decisions of younger generations of workers?

Q6.3 What impact could financial intermediation have on the effectiveness of retirement income policy?

Introduction

The Treasurer wrote to the Review Panel on 4 November 2008 asking it to bring forward its consideration of the retirement income system. This is to allow the Government to consider the issues facing the retirement income system in conjunction with those arising from the Pension Review due in February 2009. This request has not changed the original terms of reference to preserve tax-free superannuation payments for people 60 years or older. The terms of reference are included in Appendix A.

The Panel is to report to the Government its findings on the retirement income system by the end of March 2009. The Panel is seeking community input to help develop the final report. The Panel is inviting written submissions from the public by 27 February 2009. The Panel may initiate meetings with representative organisations for further discussions on the retirement income system.

This paper highlights key design issues that, in the Panel's view, would benefit from further community discussion before policy directions are determined. The issues are not exhaustive. The Panel has highlighted issues it considers to be central to the design of the retirement income system as it relates to the request in the Treasurer's letter. Consultation is not limited to these issues, although comments are encouraged on broader issues through the consultation process for the Panel's *Consultation paper*.

The retirement income system was substantially changed in the latter part of the last century to respond to one of this century's greater socioeconomic challenges, the ageing of the Australian population. This will increase demand on government support to the aged when the number of individuals of working age is declining. In reviewing the retirement income system, the Panel will focus on the features that are required to best meet the needs of society in the 21st century.

Superannuation and retirement incomes have attracted considerable interest in the consultation process. Of the approximately 500 formal submissions received by the Panel around 20 per cent focus solely on these issues or include them as part of their views on the tax-transfer system. The key messages from these submissions are outlined in this paper.

1 The retirement income system

Challenges and opportunities and their implications for the retirement income system

The Panel's *Consultation paper* sets out the challenges and opportunities that will shape Australia's future tax-transfer system. The submissions identify the following challenges and opportunities:

- the type of society in which Australians might choose to live, including considerations about the role and size of government in Australia;
- increasing globalisation and the changing pattern of world economic activity;
- demographic change, including changing patterns of workforce participation;
- climate change, the environment and sustainable economic growth;
- improving intergovernmental relationships within the Australian federation;
- improving the process of policy formation and its administration; and
- the role of technological progress.

While these challenges and opportunities relate to the whole tax-transfer system, many are also relevant to Australia's future retirement income system. Australia has supported the living standards of retired Australians, especially those unable to save for their retirement, since the early 20th century. While the Pension Review considers the adequacy of these arrangements, this review considers the appropriateness of the retirement income system for individuals able to save.

Superannuation assets are invested globally, with over 30 per cent of assets held at 30 June 2007 invested in international shares and fixed interest securities (Australian Prudential Regulation Authority 2008). Australians' retirement incomes therefore are directly linked to the changing pattern of world economic activity.

The retirement income system has a strong connection with demographic change. It affects the sustainability of the retirement income system and highlights the need to ensure it achieves a reasonable standard of living for the growing number of individuals no longer in the workforce.

Australia's retirement income system

Australia has a three pillar retirement income system with a government funded Age Pension supported by compulsory saving (the superannuation guarantee (SG)) and voluntary saving. This system ensures support for the aged once they are no longer able to work.

The Age Pension provides basic support to those older Australians with no or moderate private income or assets. Its aim is to provide an acceptable standard of living in retirement regardless of an individual's time in the workforce and access to superannuation. The Age Pension also supplements the other income of most retirees. A means test that takes into account a retiree's other income and assets determines the supplementation.

The SG requires individuals to save for their retirement and closely relates an individual's retirement income to their time in the workforce. One reason given by the government for introducing the SG was to counter the possible short-sighted behaviour of individuals to save inadequately for their retirement. However, compulsory saving may also act to counter the effects of an Age Pension and taxation on decisions to save. The promise of a means-tested Age Pension may result in people choosing not to save, or to save less than they might otherwise. The tax treatment of long-term savings can also result in individuals preferring to save less.

Under the SG, 9 per cent of an employee's remuneration is paid into a superannuation fund to support their retirement.[1] Although employers are required to make superannuation contributions on behalf of their employees, employees may have borne the cost of the SG through lower wage growth at the time the SG was increased. This was outlined in the government paper announcing the SG:

> A major challenge for retirement incomes policy is the need for current consumption to be deferred in favour of future income in retirement … No loss of remuneration is involved in meeting this national challenge. What is involved, rather, is forgoing a faster increase in real take-home pay in return for a higher standard of living in retirement (Australian Government 1992).

The voluntary savings pillar enables individuals to choose how much they save, and the investment vehicle in which they save, to achieve a higher retirement income. This pillar includes superannuation contributions above the SG and non-superannuation savings, such as deposits and real estate (which may or may not be used for retirement). Home ownership supports retirement income as owners do not need to pay rent and the home acts as a store of wealth that can be accessed in retirement (for example, through the use of reverse mortgages).

The compulsory and voluntary savings pillars allow individuals to self-fund higher retirement expenditure than the Age Pension provides. The government supports SG and voluntary superannuation savings through income tax concessions. However, individuals bear more risk, and potentially higher returns, on their SG and voluntary savings than under a government funded retirement income.

In the Australian system, therefore, the Age Pension provides a guaranteed income, while the income generated from the second and third pillars depends on the amount invested and returns on these investments. The level of earnings of an employee determines the superannuation contribution by the employer. The earnings of a person also enables them to make voluntary contributions and accumulate other savings. On average women have lower

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1 SG does not have to be paid if an employee earns less than $450 a month or on the amount of earnings above $38,180 a quarter. It also does not have to be paid to employees aged 70 years or older and certain employees under 18 years.

earnings than men. Many women have greater career interruptions than men, and many are more likely to work part-time due to caring responsibilities. This means the ability of many women to save and contribute to superannuation is more limited than for many men.

Although the three pillars are referred to as the retirement income system, in many ways the pillars have developed independently of each other. Appendix B provides a history of the retirement income system. The history of the system has influenced the degree of integration between the pillars. For example, different ages apply to when a person can access superannuation and the Age Pension, and there are differences in how benefits are paid. These issues are discussed in Sections 3 and 4.

Summary of key messages from submissions

Most submissions endorse the three pillar system. However, many propose changes, such as increasing the level of compulsory saving and altering the way the pillars are integrated.

Other submissions suggest that the retirement income system should allow individuals to save in retirement, encourage individuals to work into retirement, and facilitate transitions between work, self-funded retirement and the Age Pension.

One submission questions whether the concept of retirement is out-of-date given Australia's healthier aged population. It questions the overall benefits of having a retirement income system that supports the leisure of individuals who are capable of working.

Other submissions suggest that consideration be given to extending the superannuation system into a life-long savings account which can also be used for such things as education and housing.

Some submissions argue that compulsory saving has increased Australia's national saving, which may have the potential to insulate Australia from global restrictions on credit.

Objectives for a retirement income system

Guiding objectives can help set the parameters for the retirement income system. Possible objectives for a retirement income system are:

- 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;
- it should be *acceptable* to individuals, in that it considers the income needs of individuals both before and after retirement, is equitable and does not inappropriately bias other saving decisions;
- it should be *robust*, in that it appropriately deals with investment, inflation and longevity risk;

- it should be *simple and approachable*, in that it allows individuals to make decisions which are in their best interests; and

- it should be *sustainable*, in that it is financially sound into the future and detracts as little as possible from economic growth.

These objectives place various responsibilities on individuals and the government. Sections 2 to 6 discuss each of these objectives with regard to the retirement income system.

The evolving retirement income system

The relatively recent increase in the SG to 9 per cent, in 2002, means that the SG will affect retirees in different ways. For example, the standard of living of retirees will significantly improve during the transition to a mature SG system in 2037 (after 35 years of work).

Table 1.1 shows how replacement rates for individuals will change over time (based on the Age Pension and SG savings). 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 $75 in retirement compared to $100 before retirement.

Table 1.1: Replacement rates for an individual aged 60, 40 and 20 years in 2008 who retires at age 65 years(a)

Income as a proportion of AWOTE(b)	Individual's age (in years) in 2008		
	60	40	20
	%	%	%
0.75	63	83	89
1.0	54	73	78
1.5	43	61	67
2.5	30	49	60

(a) Appendices D and E provide further discussion of replacement rates and how they are calculated.
(b) AWOTE is average weekly ordinary time earnings and is approximately $1,150 a week.
Source: Australian Treasury projections.

The average replacement rate in OECD countries is currently 84 per cent for a 20 year old earning the average wage and retiring at the eligibility age for a pension. However, concerns regarding the sustainability of some retirement income systems around the world have seen reforms such as increasing the Age Pension age, reducing incentives for early retirement and changing the way benefits are calculated and indexed. These reforms will result in the average replacement rate falling to 70 per cent by 2040 (Martin and Whitehouse 2008).

The transition to a mature SG system will shift the system from one where superannuation supplements the Age Pension to one where the Age Pension supplements superannuation. Table 1.2 shows how the Age Pension will decrease as a proportion of retirement expenditure over time. The Age Pension will continue to be an important source of income for median income earners (around 75 per cent of average weekly ordinary time earnings (AWOTE)) and average income earners. It will also support the retirement income of higher income earners during the transition to a mature retirement income system. The Age Pension will continue to support the retirement income of individuals earning over twice AWOTE even after the SG is mature.

Table 1.2: The changing retirement income system[(a)]

Age Pension as a proportion of retirement expenditure over time

Income as a proportion of AWOTE(b)	Year of retirement (at age 65)			
	2010 %	2020 %	2030 %	2040 %
0.75	79	68	59	50
1.0	73	60	50	41
1.5	63	48	36	26
2.5	59	38	24	15

(a) Appendices D and E provide further discussion of replacement rates and how they are calculated.
(b) AWOTE is average weekly ordinary time earnings and is approximately $1,150 a week.
Source: Australian Treasury projections.

Setting the retirement income parameters

The parameters of the future retirement income system will depend on its desired outcomes. Box 1.1 sets out reasons why the government may get involved in the retirement savings decisions of individuals. The Age Pension will affect how the system achieves its desired outcomes. An Age Pension intended to supplement retirement income will influence retirement income differently to one designed as a safety net.

For example, if the intention of the system is to achieve a replacement rate of expenditure before retirement, an Age Pension that supplements retirement income will mean the compulsory savings rate can be lower than if the Age Pension is a safety net for those unable to save. A universal Age Pension (not means-tested) would reduce the overall levels of compulsory savings and concessions required to reach a given replacement rate. In this system, the total cost of government intervention would depend on the level of support to be provided to individuals through tax concessions and the Age Pension. If a universal Age Pension were to be paid, equity issues would have to be considered.

Alternatively, if the intent of the retirement income system is to ensure a minimum level of income for the duration of an individual's retirement, the Age Pension would act as a safety net. Individuals would then decide to save more if they wanted a higher retirement income. In this case the government could choose to fully fund this income or require individuals to partly fund it based on means. [2]

2 To purchase an Age Pension on the market, a 65 year old male would have to invest $289,000 (Dunsford and Wickham 2008). This figure would be higher if it included the other concessions provided to Age pensioners. Dunsford and Wickham estimate this cost would reduce to $240,000 if the individual purchased the Age Pension from the government, as the government can be less conservative with its investments than a private company.

Box 1.1: Why do governments have retirement income systems?

The reasons why governments establish a retirement income system include:

- Equity — the community may consider the retirement income of some retirees to be too low. Equity can be targeted in a number of ways. For example, governments can require people to save a minimum amount of income for their retirement and/or redistribute taxes to retirees with low incomes.

- Risk — markets may not provide sufficient opportunities for people to reduce the amount of risk they bear. A common market problem is 'asymmetric information', where potential borrowers know more about their ability to repay loans than lenders. Due to this information asymmetry markets may under-provide financial products such as reverse mortgages or life and income insurance. Government can also use the retirement income system to spread risk between itself and individuals, as well as between different groups in the community and between younger and older generations.

- Myopia (short sightedness) — some people may not effectively plan for their retirement, for a variety of reasons. Different reasons may require different policy responses. For example, providing more information about the future costs in retirement may enable people to better plan their financial arrangements.

- Institutional failure — some institutions may set poor incentives for saving. For example, income taxes reduce the value to saving and future consumption and therefore encourage less saving. Government may need to redress such institutional failures through retirement income policy.

International retirement income systems

Similar to Australia's Age Pension, other OECD countries provide a taxpayer funded minimum retirement income which is typically expressed as a percentage of average earnings. In many countries such pensions are means-tested. This supports individuals whose connection with the workforce does not allow them to provide for themselves in retirement.

These countries also have an additional element to their retirement income system aimed at maintaining higher incomes in retirement, which is generally linked to earnings from work. The design of this element varies across countries in terms of: the source of funding (employee, employer, or government); whether it is based on defined benefit or defined contribution schemes; whether it is administered by the government or the private sector; and indexation arrangements (whether through price, wage or other adjustment mechanisms).

The majority of OECD countries have national social insurance systems, which pay a guaranteed retirement income (a defined benefit) and may be funded by individual contributions and levies on wages, and supplemented from government revenue. The guaranteed retirement income is normally an after-tax replacement of an individual's before-retirement income, dependent on eligibility criteria such as their time in the workforce and period of contributions. This income is also supported by voluntary employer or employee retirement funds in some countries.

Other OECD countries finance this element through mandatory defined contribution schemes. In Australia this is done through the SG. Under these schemes, individuals fund a proportion of their retirement income by making contributions to a superannuation fund. Unlike the social insurance model, the risks associated with investment, longevity and inflation are borne by the individual. However, these systems reduce the risk that future governments will alter entitlements, as may occur under a national social insurance system.

The World Bank promotes multi-pillar retirement systems as outlined in Appendix C.

Consultation question

Q1.1 In considering the future of Australia's retirement income system, which objectives are relevant in setting retirement income policy? Does the current system of the Age Pension and compulsory and voluntary savings meet these objectives? If not, how should the system be changed to meet these objectives?

2 A broad and adequate retirement income system

A broad and adequate retirement income system protects those who are unable to save against poverty in their old age, and provides the means for individuals to save for their retirement.

Australia's retirement income system accommodates the needs of individuals with different circumstances. This includes those with a full working life and those who are unable to work. The Age Pension acts as a safety net to support those with a short work history, while the SG and voluntary savings enable individuals with a long work history to fund a higher retirement income.

However, not all individuals have the same expectations about their standard of living in retirement. While some may regard a particular level of retirement income as adequate, others may regard it as too much or too little. Individuals therefore have a responsibility for achieving their desired retirement income level where it differs from that provided by the Age Pension and compulsory saving.

Summary of key messages from submissions

Submissions back the Age Pension as a means of providing basic support to those unable to save for their retirement. Many submissions comment on the significant effect introducing the SG will have on the standard of living of future retirees and call for it to include more individuals.

One submission calls on the Panel to set a clear aspirational goal for retirement incomes.

A range of submissions argue that the Age Pension should allow full rate Age pensioners to live with dignity and have a small level of discretionary income.

Many submissions comment on the retirement incomes of individuals who are not covered by the SG. Most of these submissions call for the self-employed to be brought into the SG system. A number express concern that the current exclusion of the self-employed from the SG system means that employers may prefer individuals to be independent contractors instead of employees.

Other submissions call for the removal of the $450 per month exemption that determines if the SG is paid to employees and for the inclusion of individuals on workers compensation, the long-term unemployed and carers. Others recommend allowing individuals who are not working to be eligible for the government superannuation co-contribution, or for the government to pay superannuation contributions into an account on their behalf.

One submission argues that increasing compulsory superannuation contributions or concessions is unlikely to significantly increase retirement incomes for individuals with broken work patterns. The submission argues that this raises the need for an adequate Age Pension as part of the retirement income system.

Some submissions raise taxing foreign source pensions in the same way as superannuation. Others suggest that expatriates should be allowed to transfer retirement savings accumulated in another country into Australia's superannuation system without limit.

Adequacy of the retirement income safety net

The Pension Review

The Age Pension is intended to provide a basic acceptable standard of living, taking into account community standards. It is paid to Australian citizens and permanent residents irrespective of previous workforce participation or earnings. The balance between the role of the Age Pension as a safety net and its role as a supplement to retirement savings is a threshold issue for the design of the Age Pension and its integration with the retirement income system.

The issue of the adequacy of the Age Pension in its role as a safety net is a key focus of the Pension Review. It is also examining relative needs, for example the relative expenditure needs of single pensioners compared to couple pensioners, other support mechanisms and the system's sustainability. The Pension Review is examining a range of benchmarks and indicators, such as:

- budget standards, which involve developing detailed household budgets specifying the items that a household needs to achieve a particular standard of living;
- relative income poverty measures;
- international comparisons;
- changes in real pension rates over time (that is after adjusting for inflation); and
- wellbeing indicators, which look beyond income to explore how retirees perceive their retirement (for example, whether they believe that their overall standard of living is similar to, worse than, or better than before they retired).

Another key question about the adequacy of the Age Pension in its role as a safety net is that of indexation and the benchmark against which the Age Pension is set. That is, it is necessary to consider how to maintain adequacy over time as well as at a particular point in time. Currently, the Age Pension is indexed in line with the Consumer Price Index, or set at a benchmark of 25 per cent of male total average weekly earnings, whichever is greater.

Income support is only one element of policy assisting those in need. Other support is provided through services and concessions that are more closely related to the specific needs and circumstances of older Australians, such as assisting with the needs associated with illness, disability or caring responsibilities.

This review into the retirement income system will not reconsider the issues evaluated by the Pension Review.

The outcomes of the retirement income system

The outcomes of the retirement income system are commonly discussed in terms of whether they are adequate or not. There is no consensus as to how to measure adequacy for an individual, and any decision needs to take account of what benchmark is used to judge adequacy. Individuals will also have different ideas on what is adequate depending on their pre-retirement income and other circumstances such as whether they have children or own a home. It is also challenging to measure the value a retiree places on their leisure (Box 2.1).

Common adequacy benchmarks used to assess the retirement income system are replacement rates, budget standards and wellbeing measures. A description of these measures is outlined in Appendix D. The most commonly used measure is the replacement rate, which this section uses to discuss the outcomes of the retirement income system.

Replacement rates arising from the Age Pension and SG

Treasury uses replacement rates to project the outcomes of the retirement income system. Some replacement rates compare the first year of retirement expenditure with expenditure in the last year of an individual's working life. Bingham and Rothman (2004) consider this approach to be misleading as it does not include the effect of real increases in the Age Pension and overstates the effect of the assets test in the first year of retirement.

Treasury projections use an after-tax income, based on average expenditure over an individual's retirement. Table 2.1 sets out Treasury projections of the replacement rate for an individual who retires after a full working life (35 years) of having received 9 per cent SG.

Table 2.1: Replacement rates based on income[a] — using CPI discount[b]

Income as a proportion of AWOTE(c)	Replacement rate %
0.75	79
1.0	68
1.5	56
2.5	48

(a) Appendices D and E provide further discussion of replacement rates and how they are calculated.
(b) Consumer price index.
(c) AWOTE is average weekly ordinary time earnings and is approximately $1,150 a week.
Source: Australian Treasury projections.

Replacement rates fall as income increases, while overall retirement expenditure grows as income increases. The average expenditure for an individual on 75 per cent of AWOTE is projected to be $46,153 (in 2008 dollars) and $68,761 for an individual earning 2.5 times AWOTE.

Table 2.1 uses consumer price inflation to determine how much purchasing power an individual retains in retirement. Treasury considers that adjusting for consumer price inflation best indicates whether an individual's real standard of living has increased over time. Some groups argue that using inflation to determine purchasing power overvalues the increase in living standards, and wages is a better indicator. Table 2.2 shows the replacement rates for the SG and the Age Pension using wages instead of inflation to determine changes in purchasing power. The use of wages reduces the replacement rates shown in Table 2.1, as the Age Pension is kept constant in today's dollars, while its value increases over time if inflation is used.

Table 2.2: Replacement rates based on income[a] — using wages discount[b]

Income as a proportion of AWOTE(c)	Replacement rate %
0.75	65
1.0	56
1.5	47
2.5	40

(a) Appendices D and E provide further discussion of replacement rates and how they are calculated.
(b) Increases deflated by wages.
(c) AWOTE is average weekly ordinary time earnings and is approximately $1,150 a week.
Source: Australian Treasury projections.

Box 2.1: Retirement and leisure

During their working life, individuals will divide their time between paid work and other activities that they may prefer doing, such as hobbies, work around the home or volunteer work. In many cases, the desire to attain a particular level of income drives the choice to work. Among other factors, individuals' wellbeing will be determined by their spending power and time spent outside paid work.

When individuals retire, they have more leisure time to devote to other activities. This is of value to retirees and influences their perceptions of their wellbeing in retirement. Findings from the Household Income and Labour Dynamics in Australia Survey, Wave 3, 2004, reveal that around 73 per cent of retirees believe their standard of living is similar or better than before they retired even though most retirees have less spending power than when they worked. This may reflect greater flexibility in the use of their time.

Replacement rates compare a person's spending power in retirement to what they had while they worked. This is different to a comparison of their wellbeing, which would include the value of increased leisure time in retirement, among other factors.

Aggregate replacement rates

Replacement rate measures are generally calculated using a retirement income comprising the Age Pension and superannuation accumulated under the SG. The third pillar of the retirement income system, voluntary savings, is not included as individuals use this pillar in different ways.

A significant proportion of individuals have superannuation contributions greater than the 9 per cent SG. An estimated 1.25 million individuals make salary sacrifice contributions (ABS 2008). Salary sacrifice contributions are more likely to be made by older individuals (around 22 per cent of those aged 55-64 years, compared to 3 per cent of those aged 15-24 years) and individuals with higher wages (around 29 per cent have gross weekly incomes of $2,000 or more, compared to 2 per cent with gross weekly incomes of less than $300). The Australian Treasury, using contribution data from 2004-05, estimates that 2.5 million individuals have superannuation contributions above 9 per cent. Individuals also make voluntary after-tax superannuation contributions and have assets outside of superannuation.

Including these additional savings significantly increases replacement rates. Table 2.3 shows aggregate replacement rates for individuals with superannuation and other savings. The rates are calculated on an average basis for these individuals. They also take into consideration the various retirement ages and workforce participation of individuals within this group. They do not include the benefits an individual receives from owning their own home (not having to pay rent) or if they generate an income from their home through the use of a reverse mortgage.

Table 2.3: Aggregate replacement rates[(a)]

Income range	Replacement rate if retiring in 2040-41
	%
Low income earner — 2nd Decile	80
Middle income earner — 5th Decile	86
High income earner — 8th Decile	89

(a) Appendices D and E provide further discussion of replacement rates and how they are calculated.
Source: Australian Treasury projections.

Government support versus self-provision

Debate on the adequacy of the retirement income system is ongoing. As a concept, adequacy can range from ensuring a minimum retirement income sufficient for an individual to afford the basics of participating in society, to providing an income which meets an individual's retirement income expectations. The concept of adequacy for the retirement income system will significantly affect the extent to which the outcome is supported by the government (through the Age Pension, tax concessions and other incentives) and the individual (through saving).

The Senate Select Committee on Superannuation (2002) suggested replacement rate targets as an appropriate objective. However, replacement rate targets can result in unintended consequences and need to be carefully considered. Too high a target can result in individuals forgoing more consumption during their working life and saving more than they consider necessary to fund their retirement. This may also result in excess saving being transferred to younger generations. It may also encourage early retirement, which could create problems in an economy with an ageing population. Too low a target may result in insufficient retirement income for individuals on low incomes during their working life.

The trade-offs associated with reaching a target need to be considered. For example, if achieving a replacement rate for all income earners is considered appropriate, how is this to be achieved? It could include relaxing eligibility rules so more individuals receive some part of the Age Pension or supporting savings with greater concessions. Alternatively, an increase in compulsory saving could make it easier for higher income earners to attain the replacement rate. The first option would reduce the progressivity of the system and increase the tax burden. The second option may adversely affect the living standards of low and middle income earners during their working years by requiring them to save more than they prefer.

Other decisions would be required if the system was intended to provide a particular income level (benchmark income). For example, at what level would the government's contribution be set and how much government support would be needed once an individual achieved the benchmark income? Depending on the benchmark income this may be more progressive than a system aimed at providing a replacement income.

Retirement incomes for non-employees and immigrants

While the SG provides comprehensive coverage of employees, for some groups it will have less of a role in providing a retirement income. These include individuals with broken work patterns (intermittent workers, carers and individuals with disabilities), those with income less than $450 per month and the self-employed. The retirement income system may have different results for immigrants, and expatriates returning to Australia, depending on their age when they arrive in, or return to, Australia and any assets or savings which they can transfer to Australia.

Individuals with broken work patterns

An individual's retirement income depends on their savings, largely from their earned income. Therefore, periods outside the workforce not only decrease an individual's standard of living before retirement but also in retirement. Women are more likely to have career interruptions because of caring responsibilities, and are therefore not able to benefit from superannuation policies in these periods.

For many individuals with broken work patterns, or no work history, changes to superannuation policy may have minimal effect on their retirement income.

Policies which support an efficient, robust economy and remove disincentives to work may have a greater effect on these individuals' retirement income than superannuation policies. For example, policies which support child care may encourage more women to return to the workforce. This may have a greater influence on their retirement income than increasing superannuation concessions.

The Age Pension is likely to provide the majority of retirement income for individuals with broken work patterns. Therefore, consideration of the adequacy of the Age Pension is likely to have the most immediate impact on their retirement income. The Pension Review is considering this issue.

Immigrants and returning expatriate Australians

Immigrants have different experiences with the retirement income system depending on their age, skills and savings. Immigrants who arrive in Australia aged in their twenties are more likely to have a similar experience as an Australian-born resident. An immigrant in their forties will have less time to accumulate SG if they retire at 65 years.

Around 80 per cent of permanent immigrants are aged less than 35 years. Over two-thirds arrive in Australia as skilled migrants. This suggests most immigrants should have a reasonable period in the workforce. As with individuals with broken work patterns, the Age Pension is likely to provide the majority of the retirement income for those immigrants who may not have a full working life in Australia.

Expatriate Australians also have different circumstances. Like some immigrants, many expatriates will have built up savings and assets overseas which they can live on in retirement in Australia. Others may not have many assets but may qualify for support from another country's retirement income system. Some submissions raise the taxation of this foreign sourced income in Australia and recommend treating this income like superannuation. Other submissions note that some expatriates are unable to transfer equivalent superannuation savings in overseas funds into Australian superannuation funds if they are greater than the cap on after-tax contributions. This cap is $150,000 a year, however, individuals under age 65 years can bring forward up to two years of future contributions.

The self–employed

Submissions have called for the self-employed to be included in the compulsory superannuation system. Unlike employees, the self-employed have different characteristics and generally fall into two main categories:

- those with minimal business assets; and
- those who have business assets which they can sell to potentially finance their retirement.

The proportion of the working population that is self-employed has been gradually decreasing over the past two decades. At the start of the 1990s, approximately 15 per cent of the work force was self-employed. Today the proportion is around 12 per cent.

Although they are not required to make superannuation contributions, many self-employed individuals do so voluntarily. Approximately two-thirds of owner-managers in unincorporated enterprises (a proxy for the self-employed) make superannuation contributions (ABS 2008). The self-employed may be eligible for tax deductions and the government co-contribution for the superannuation contributions they make.

Many self-employed also save outside superannuation, including through their business. Taking into account wealth held outside of superannuation for individuals in the 55-64 years age group, the self-employed have a higher proportion of individuals with assets above $150,000 than full-time employees. Many self-employed may qualify for the small business capital gains tax concessions intended to encourage investment in their business and use the proceeds from the sale of these assets for retirement purposes.

The exclusion of the self-employed from the SG can affect the choice of whether an individual works as an employee or is self-employed. For example, an individual who can attain total remuneration of $50,000 as an employee or in self-employment would retain more of their earnings in that year if they were self-employed and did not make a superannuation contribution. Some submissions also suggest that some employers prefer independent contractors to employees. However, there are circumstances where a business will have to make contributions under the SG system for an individual who is an independent contractor.

The self-employed may prefer to have access to liquid savings rather than superannuation, given the higher risks associated with being self-employed. Requiring compulsory superannuation saving may also influence the business decisions of the self-employed especially in the establishment phase of their business.

Consultation questions

Q2.1 As the SG system matures, it will become a greater part of an employee's retirement income. What are the implications for individuals partially or fully excluded from the mature SG system (the self-employed, individuals with broken work patterns such as carers, women and migrants), and how can the retirement income system best accommodate these groups?

Q2.2 Noting that the adequacy of the Age Pension is being considered by the Pension Review, what is an appropriate concept of adequacy for the retirement income system? Should it be to ensure there is a minimum level of income in retirement, to replace a proportion of income earned prior to retirement, or some other alternative?

Q2.3 What should the role of the government be in assisting individuals to meet their retirement income expectations in relation to the support provided by the Age Pension, the level of compulsory savings and incentives to make additional savings? Should the role of government change as an individual's income increases over their working life?

3 An acceptable retirement income system

The parameters of the retirement income system need to be acceptable to the community. Issues can include: the effect of compulsory saving on pre-retirement standards of living; whether an individual's circumstances affect access to compulsory saving or tax concessions; and the perceived equity of the arrangements across the income scale.

Summary of key messages from submissions

A frequent message in submissions is the need to increase compulsory savings with targets being 12 or 15 per cent of remuneration common. The proposals include increasing the SG or requiring higher employee contributions. This is seen as particularly important for individuals with broken work patterns to increase their retirement income.

There is broad support for superannuation tax concessions. Submissions refer to the findings in the Australian Treasury's 2008 paper *Architecture of Australia's tax and transfer system (Architecture paper)* that around 2.4 million individuals either receive no or negligible concessions on their superannuation contributions. A number of submissions propose a rebate of tax to compensate low income earners for contributions tax paid. Another submission suggested removing tax on compulsory contributions.

Many submissions suggest increasing the government co-contribution and extending it to more individuals to encourage greater voluntary savings.

Some submissions raise the current taxation of superannuation and the benefits it provides higher income earners. One submission considered that an efficient system of tax concessions would encourage saving by low-income to middle-income earners rather than high-income earners. Another submission suggests superannuation contributions should be treated as remuneration and taxed as such.

A submission argues that it is inequitable for assets supporting superannuation income streams to be tax-free. It argues this is particularly the case with transition to retirement pensions which allow older working Australians to shift their superannuation fund assets into tax-free pension products.

Access to concessions is raised in many submissions, in particular: greater deductibility of contributions; the length of time individuals can make superannuation contributions; and the treatment of non-superannuation income of members of taxed and untaxed funds.

Some submissions consider that insurance purchased outside of superannuation should be deductible, as it is if purchased within a superannuation fund.

The effect of compulsory saving on pre-retirement living standards

Various submissions recommend increasing the level of compulsory saving. Proposals include increasing the SG or requiring employees to make additional contributions. Under either proposal the increased payments are likely to fall on the employee, either directly from their wages or, if the SG is increased, potentially through reduced wages growth. An implication of increasing compulsory savings is that it will require individuals to have a lower standard of living during their working life, to increase their standard of living in retirement.

Compulsory saving may not be acceptable to individuals if they have to forgo too much consumption before they retire. It is generally accepted that for most individuals a replacement rate of less than 100 per cent is appropriate, as they do not have costs associated with working, raising children, paying off their mortgage or accumulating wealth.

Increasing the amount of saving through superannuation may also be inconsistent with preferences about the form in which savings are held. For example, individuals with periods outside the workforce may prefer to have their savings in a more accessible vehicle than superannuation, so they can draw on them during these periods. This may also apply to groups with lower life expectancies. Others may prefer more flexibility to allow investment in housing or other assets.

An increase in the SG could increase employer costs, especially in the short-term, if they are unable to share the cost with employees. If an employer is unable to absorb these costs they may retrench workers or not take on new employees. The overall impact on employment would depend on the economic circumstances at the time of any increase in the SG.

The effects of an increase in compulsory saving on replacement rates are shown in Table 3.1.

Table 3.1: Effect of increasing compulsory saving on replacement rates[(a)]

Saving rate	AWOTE(b)			
	0.75 %	1.0 %	1.5 %	2.5 %
9 per cent SG	79	68	56	48
12 per cent SG	84	74	62	55
15 per cent SG	88	78	67	59

(a) Appendices D and E provide further discussion of replacement rates and how they are calculated.
(b) AWOTE is average weekly ordinary time earnings and is approximately $1,150 a week.
Source: Australian Treasury projections.

Increasing the SG to 12 per cent for an individual on median earnings (around 75 per cent of AWOTE) would increase aggregate retirement expenditure by around $50,600 (over 23 years), while reducing pre-retirement expenditure by $33,840 (over 35 years). Increasing the SG to 15 per cent would change expenditure by $78,643 and $61,457, respectively.

Increasing the SG rate also has a cost to government revenue as superannuation contributions are generally taxed less than income. If the increase were phased in at 1 per cent every two years, the cost to revenue in 2014-15 (the year it would reach 12 per cent) is estimated to be $1.9 billion per year. Although superannuation tax revenue would rise, this would be more than offset by a loss of personal income tax revenue. There would be a longer-term saving on Age Pension outlays.

Taxation and other concessions

In addition to the Age Pension, the government supports the retirement income system through taxation and other concessions such as the government superannuation co-contribution for low-income and middle-income earners. Page 25 of the *Architecture paper* outlines the taxation of superannuation.

The Age Pension is regarded as taxable income. However, the effect of the pensioner tax offset means that individuals receiving a full rate Age Pension do not pay tax. The senior Australians tax offset and the low income tax offset also reduce the tax paid by many part rate pensioners. The taxation of older Australians is outlined in Section 4.1 of the Panel's *Consultation paper*.

Rationale for concessional taxation arrangements

Tax concessions were part of the two pillar retirement income system that existed before the SG was introduced. The concessions sought to encourage individuals to save for their retirement and reduce their reliance on the Age Pension. One stated reason for introducing the SG was that these concessions were not effective in encouraging private voluntary savings. However, following the introduction of the SG, both compulsory and voluntary savings through superannuation continued to be concessionally taxed.

Concessions for compulsory savings act as an additional level of government support for the provision of retirement income. The tax concessions for compulsory savings do not encourage savings but may be seen to compensate individuals for the inability to use these savings for other purposes, which they may value more highly than retirement savings. Providing concessions to compulsory saving may also reduce the need for individuals to make additional voluntary saving.

The incentives to make voluntary contributions, such as salary sacrifice, support an individual's decision to make additional savings if they want a retirement income higher than that available under the Age Pension and SG. Individuals who are ineligible for the SG can claim a deduction on their superannuation contributions. This provides some support to individuals such as the self-employed. However, it is unclear from research whether tax concessions encourage additional saving.

The taxation of other voluntary saving is discussed in Sections 3.2 and 6.7 of the Panel's *Consultation paper*.

Individuals can access their superannuation from age 55 years as an income stream without the need to retire. This policy assists individuals in their transition to retirement, by using their superannuation to support a move from full-time to part-time work. An emerging strategy among older workers, aged 60 years or older, is to use this policy to receive a tax-free income from superannuation at the same time as making salary sacrifice superannuation contributions from their work income. This reduces the effective rate of tax on part of their work income to the 15 per cent tax paid on their superannuation contributions. Table 3.2 shows the effect of this strategy on the amount of tax paid.

Table 3.2: Transition to retirement strategy — tax impact

	Salary	
	$50,000 $	$100,000 $
Without transition to retirement		
Income tax and Medicare	8,850	27,500
Net income	41,150	72,500
With transition to retirement		
Salary sacrifice	25,000	50,000
Superannuation income	16,525	31,350
Income tax and Medicare on remaining $25,000/$50,000	375	8,850
Tax on super contributions	3,750	7,500
Net income	41,150	72,500
Reduction in total tax	4,725	11,150

Note: 2008-09 tax scales are used. The individual is assumed to have no income other than salary and is aged 60 to 64 years. The examples are constructed to achieve the same after-tax income — that is, the tax saving is applied to achieve higher superannuation balances. To receive a transition to retirement pension of the amounts shown, the individual must have a superannuation balance of at least 10 times the pension.
Source: Australian Treasury estimates.

Equity of the taxation arrangements

Savings invested in superannuation are generally not taxed at the individual investor's personal tax rate (income streams paid from an untaxed superannuation fund are taxed at personal tax rates with a rebate). Instead superannuation contributions and earnings are taxed at a flat rate of 15 per cent within the fund. This tax structure means that superannuation concessions are higher for an individual on a higher personal tax rate while an individual on a low personal tax rate receives little concession on their contributions.

The proportion of concessions that flow to individuals on higher personal tax rates has been increasing in recent years due to reductions in personal income tax. For 2005-06, it is estimated that 5 per cent of individuals accounted for over 37 per cent of concessional superannuation contributions. Concessionally taxed contributions include SG contributions, salary sacrifice and deductible contributions by the self-employed. This distribution reflects the fact that these individuals are paid more SG contributions, and have greater capacity to make voluntary superannuation contributions within the contribution limits.

To limit the concessions available to an individual there are two caps on the amount of contributions an individual can make each year. Individuals can make up to $50,000 a year (indexed) of before-tax (concessional) contributions (those made by an employer or that are tax deductible). Individuals aged 50 years or older can contribute up to $100,000 a year until 30 June 2012. A cap of $150,000 a year (indexed) applies to personal contributions made from after-tax income. Individuals under age 65 years can bring forward up to two years of future after-tax contributions.

Higher income earners are also likely to benefit to a greater extent from the tax exemption on earnings on assets supporting superannuation income streams, as they have more assets and are likely to live longer on average than individuals from lower income groups.

While the taxation concessions benefit those on higher incomes, this is reduced to an extent by other components of the retirement income system. In particular, the Age Pension income and assets test arrangements are more likely to affect higher-income earners than low-income earners.

The government superannuation co-contribution also targets benefits to those on low to middle incomes. In this way the co-contribution distributes concessions to individuals on middle personal tax rates who are able to make additional contributions.

Box 3.1: Concessionality of the superannuation taxation arrangements[(a)]

Under a comprehensive income tax benchmark the concession to superannuation is the difference between the tax paid if the superannuation contribution and the earnings were taxed as income at the individual's personal tax rate (plus the Medicare levy) and the tax paid in the fund (generally 15 per cent). Under this benchmark the superannuation concessions have an estimated cost to revenue of over $26 billion in 2007-08 (Australian Treasury 2007).

An alternative way to calculate the value of the tax concession is to use an expenditure tax benchmark. The two types of expenditure tax benchmarks are: a pre-paid expenditure tax based on direct taxation of labour income with an exemption for saving; and a post-paid expenditure tax based on the taxation of a direct measure of expenditure or of goods and services.

Under the pre-paid expenditure tax benchmark, the value of the concession is the difference between the tax paid if the superannuation contribution were taxed as income at the individual's personal tax rate (plus the Medicare levy) and the tax paid in the fund, less the tax paid on earnings in the fund. Benefits are tax exempt under this benchmark, which is consistent with the tax exemption of superannuation benefits in Australia's retirement income system. Under this benchmark, the superannuation tax concessions would have an estimated aggregate cost to revenue of $4.6 billion in 2007-08.

Under the post-paid expenditure tax benchmark, both contributions and earnings would be tax-exempt but benefits would be fully taxable when paid. Under this benchmark the tax concession is expected to be less than under the pre-paid expenditure tax benchmark, as individuals will generally have a lower tax rate on their retirement income than their income while working.

Under all these benchmarks, superannuation is taxed concessionally. However, the concessions are heavily weighted to individuals on higher personal tax rates.

(a) These estimates are not necessarily indicative of the cost of the superannuation concessions over the long term. The tax concessions help to reduce budgetary expenses in future years, particularly Age Pension payments, through the effect of the means tests.

Access to concessions

The superannuation tax concessions are not universally accessible. Some submissions note that employees who cannot make salary sacrifice contributions do not have the same access to contributions as employees who can. Other submissions raise a concern that individuals aged over 70 years are not paid the SG and those aged 75 years or older are unable to make superannuation contributions and must pay tax on their non-superannuation investment income. There are also concerns that self-funded retirees are not eligible for the concessions paid to Age pensioners.

Some submissions raise concerns about the tax treatment of benefits from a taxed and untaxed superannuation fund, especially the flow-on effect to the taxation of other income. Benefits from a taxed superannuation fund are tax exempt when paid to an individual aged 60 years or older, while benefits from an untaxed superannuation fund are included in assessable income but are eligible for a 10 per cent offset. This affects the taxation of the non-superannuation income received by a member of an untaxed fund. The example in Table 3.3 was submitted to the Panel.

Table 3.3: Tax treatment of non-superannuation income of members of taxed and untaxed funds

	Superannuation income	
	Taxed $	Untaxed $
Superannuation pension	40,000	40,000
Non-superannuation income	20,000	20,000
Total income	60,000	60,000
Tax(a)	1,169	8,900
Net income	58,831	51,100
Tax on $20,000 non-superannuation income	1,169	7,100

(a) 2008-09 tax scales and individual below Age Pension age. The calculation for the untaxed fund member includes the 10 per cent offset.
Source: Superannuated Commonwealth Officers' Associations (Federal Council) Inc. submission (2008).

The example reflects taxes at the point the pensions are paid. The individual taking a pension from the taxed fund has already pre-paid tax on this pension amount. If it is assumed that this is at the rate of 15 per cent the member of the taxed fund has already paid tax on their pension of $7,058. This increases the tax paid by the member of the taxed fund in the above example to $8,227. Tax paid in this example reduces to $7,058 if the individual is eligible for the senior Australians tax offset.

There are other examples where the retirement income system treats individuals differently. An individual can make contributions up to age 65 years without having to work but must work to make contributions after age 65 years. The SG is paid up to age 70 years. After that age, an individual is not paid SG but can ask their employer to make salary sacrifice contributions up to age 75 years.

Consultation questions

Q3.1 Do the settings of the retirement income system, such as the level of SG and access to concessions, adequately consider the needs and preferences of individuals both before and after retirement?

Q3.2 Is the current level of superannuation income tax concessions appropriate and sustainable into the future? Are the current concessions properly targeted and, if not, how should they be reformed?

4 A robust retirement income system

The way the retirement income system deals with risk affects its robustness. These risks include: governments failing to provide entitlements (political risk); sustained falls in the market price of assets (investment risk); increases in the cost of living (inflation risk); and the individual outliving their capital (longevity risk). The amount of risk borne by the government and the individual is an important consideration in setting the framework of the retirement income system.

Summary of key messages from submissions

One submission argues that the move away from the pooling of risks, as exists in defined benefit funds, has moved more risks to individuals. The submission states this affects confidence in the superannuation system and attitudes to risk.

Many submissions argue that the retirement income system needs to deal better with the risk associated with individuals outliving their assets. Most suggest that individuals be required to take all or part of their superannuation as a guaranteed income for life. It is argued that the government should issue bonds which product providers could buy to support these products. Others propose greater concessions, such as the return of an assets test exemption, to encourage the take-up of income streams.

Some submissions state that requiring individuals to take income streams is consistent with the existence of tax concessions to support superannuation.

One submission argues retirees should not have to draw down their superannuation assets, to provide them with flexibility to prolong their assets.

Another submission identifies the benefits that housing can play in combating longevity risk, given the owner does not have to pay rent.

Investment risk

In developing a multi-pillar system, the World Bank (1994) recommends that governments consider workers' exposure to investment risk within reasonable bounds. The way Australia’s retirement income system deals with investment risk will become more important as the SG becomes as a greater proportion of retirement income.

Investment risk has two elements. The first involves inappropriately allocating assets during the accumulation of an individual’s benefits. Over the long-term, investments in low-risk, low-return assets can reduce the benefits that an individual can take into retirement. This will affect their ability to deal with longevity and inflation risks.

A higher level of investment risk can be positive as individuals can receive, on average, higher investment returns than from a system based on more conservative investments.

The second involves the impact that substantial falls in investment returns have on an individual once they retire. A rule of thumb is that a diversified portfolio of assets will experience a negative return once every seven years. As life expectancies increase, retirees could expect assets to fall perhaps two to three times over their retirement. The effect of a fall in investments can be magnified depending on how soon it occurs before or after they commence retirement.

The government shares investment risk through the interaction of the Age Pension with other retirement income. During periods of negative returns, a loss of income may be made up, in part, by an individual being eligible for some, or more, Age Pension at a rate of 40 cents in each dollar of lost income. Where investment returns rise, the income test allows the government to share in these returns through reduced Age Pension outlays. Investment returns also affect Age Pension outlays through the assets test.

Longevity and inflation risk

As superannuation becomes a larger part of an individual's retirement income, their standard of living will be determined by how they choose to draw their benefits. This choice can have a considerable influence on how they deal with the risks of inflation and longevity.

Life expectancy is an uncertainty in an individual's retirement planning. Many individuals tend to underestimate how long they will live. For many, increasing life expectancies pose a risk to the maintenance of their income.

Better integration between the Age Pension and the SG, including the age an individual can access their superannuation and how they draw down their capital, can limit these risks.

Access to superannuation

The length of the draw down period is a significant factor in determining an individual's income over their retirement. The draw down period is determined by when an individual starts to take their superannuation, how long they live and when they exhaust their assets.

The earlier an individual accesses their superannuation, the higher the risks associated with longevity and inflation. Currently, an individual can start accessing their superannuation from age 55 years. From 2015, this will gradually increase, reaching age 60 years by 1 July 2024 for individuals born after 1 July 1960, which is still below the Age Pension age of 65 years.

Aligning the eligibility age for superannuation to the Age Pension age would reduce the period individuals need to draw on their superannuation, thereby reducing the risks associated with longevity and inflation. However, some individuals have a working life interrupted by illness, unemployment or caring, for whom it may be inappropriate to delay access to their superannuation.

Draw down of superannuation

The Age Pension is a right to an income stream (depending on eligibility requirements) and cannot be commuted to an asset. By contrast, superannuation savings are a right to an asset and individuals have a choice in how they draw it down.

Requiring an amount of superannuation savings to be taken as an income stream would better integrate the Age Pension and the superannuation system and provide greater protection against longevity and inflation risks. Income streams could be purchased to receive a set income for life (a lifetime annuity) or a flexible income based on the balance of an account (an allocated pension).

Annuities provide the greatest protection against longevity risk, but Australia does not have a well-developed annuity market. Annuities can also protect against inflation if they are indexed. As annuities are a set income, they provide less flexibility on how an individual can draw down their capital. They also tend to be invested in less risky assets, which may not satisfy the risk preferences of all individuals.

Allocated pensions provide more flexibility on the draw down of capital and the way capital is invested. On average, a diversified portfolio will deliver investment returns above inflation protecting the retiree from inflation risk. Longevity risk depends on how quickly the individual draws down their capital. Investment risk also affects how an individual deals with longevity and inflation risks.

The proportion of superannuation that an individual would need to assign to an income stream is a threshold question. Alternatives include requiring an individual to take all their superannuation as an income stream at the time of retirement, or requiring individuals to insure against living beyond their life expectancy by putting aside part of their superannuation to purchase an income that commences from a particular age.

Other countries have designed their systems to provide insurance against longevity and inflation risks. The national 'social insurance' models in other countries provide a defined retirement income. In Chile, which has a privately funded retirement income system similar to Australia's, benefits must be used to fund a monthly income benefit equal to 70 per cent of the individual's most recent wage. Only the amount exceeding this benefit may be taken as a lump sum. Private employer retirement savings vehicles in the United Kingdom restrict access to lump sums to 25 per cent of the value of the benefit, with the rest to be taken as a lifetime annuity.

Allowing access to lump sums provides flexibility for events outside normal retirement income needs. Such flexibility may be a relevant feature of a retirement income system. Requiring superannuation to be taken as an income stream would limit this flexibility.

Housing

Home ownership is a significant factor in retirement planning and can be used to counter investment, longevity and inflation risk. Instead of receiving investment income, a home owner receives the benefit of not having to pay rent during their retirement. Housing is therefore a form of voluntary retirement saving.

Accommodation costs in retirement can be financed through the purchase of a home or by saving through another vehicle (with those savings to be used on housing in retirement). The approach an individual chooses to take will be influenced to some degree by the tax arrangements applying to the available options. Where home ownership is more concessionally taxed, this is likely to encourage greater ownership than if the tax treatment of housing and the alternative savings vehicle are similar. However, issues other than taxation are likely to influence an individual's decision to buy a home. For example, owner-occupied housing may provide benefits before retirement. It may also be regarded as less risky than other investments, as well as providing greater protection against increases in rent.

In addition to not having to pay rent, an individual can access the equity in their home through downsizing or through a reverse mortgage. These products allow an individual to convert the equity in their home to either a lump sum or a stream of payments. The access to capital in a home can also provide insurance against the risk of exhausting other assets while still alive. The reverse mortgage industry is still in its infancy in Australia, with approximately 1.4 per cent of individuals over the age of 60 years holding a reverse mortgage (SEQUAL 2008). The value of the market is approximately $2 billion, made up of over 33,700 reverse mortgages, with an average value of $59,000 per mortgage (Trowbridge Deloitte 2008).

Investment in the family home can result in the home being a significant asset (perhaps an individual's only significant asset) that can be drawn against in retirement. Payments from a reverse mortgage on a primary residence are treated as a loan for the purposes of the tax system and are therefore not treated as income for tax purposes.

However, if a reverse equity mortgage is taken as a lump sum, the first $40,000 is exempt from the Age Pension assets test for up to 90 days. Amounts over $40,000 are assessed under the assets test if held as an assessable asset. The whole amount is immediately assessed under deeming rules if held in a financial investment. If taken as a stream of payments, the amount drawn down is not counted in the income test.

The social security system provides additional assistance to individuals who are non-home owners. Individuals who receive the Age Pension and do not own their home may qualify for Rent Assistance if renting in the private rental market. The maximum payment is $107.20 per fortnight for a single individual with no children and $101.00 for a couple with no children.

Owner-occupied housing is exempt from the assets test. Non-home owners can accumulate higher non-housing assets ($124,500) without affecting their eligibility for the Age Pension. Implicitly valuing a person's home at a maximum of $124,500 can discourage Age pensioners from making decisions to move into more preferred housing arrangements, as it may reduce their total income because the additional income they earn by selling their house does not make up for the reduction in their Age Pension.

A broader discussion of the treatment of housing within the tax-transfer system is in Section 11 of the Panel's *Consultation paper*.

Consultation questions

Q4.1 At what age should an individual be able to access their superannuation and at what age should they become eligible for the Age Pension?

Q4.2 What is the role of individuals in dealing with investment and longevity risk in accumulating and drawing down their retirement income? Do financial markets provide the means to deal with these risks? If not, is there a role for government to address these shortcomings?

5 A simple and approachable retirement income system

The accumulation and draw down of retirement income requires individuals to make choices about the type of contribution to make, the best way to take their superannuation, and to consider the effect additional work will have on their income. The ease with which individuals can make the right choice is a mark of how simple the system is. The complexity of these decisions is influenced both by policy design and the design of superannuation products.

Summary of key messages from submissions

Some submissions discuss the need to simplify the way retirees interact with the tax-transfer system. They argue retirees must provide similar information to both the Australian Taxation Office (ATO) and Centrelink, which adds to their costs.

A number of submissions express a view that the means testing arrangements are complex and intrusive.

Some submissions argue that improving the financial literacy of households is necessary, particularly in managing their retirement income. Educating workers and retirees about the level of saving they will need for an adequate retirement income is also proposed.

A number of submissions recommend making financial advice more affordable, via tax rebates and/or deductions, to encourage more individuals to educate themselves about retirement matters.

A submission used the example of the pensioner tax offset to illustrate some of the complexity that exists in the concessions paid to retirees. This is outlined later in this section.

Some submissions claim efficiency gains would occur if the services delivered by various government departments (at the Australian, state and local levels) and by not-for-profit organisations could be streamlined. One proposal is to combine the social security and tax systems for those aged 65 years or older.

Superannuation products and the role of advice

Individuals now have a greater responsibility than in the past for providing their income in retirement. Many find it difficult to make decisions today that will affect their wellbeing in 20 to 40 years time. Developments in financial markets over the past decade have significantly increased the number of investment products, many of which are very complex. These products are now part of the broader retirement income system.

Superannuation funds have developed from offering a simple 'one size fits all' product, to most now allowing members to make decisions on how their money is invested. On average funds offer 38 investment choices (Australian Prudential Regulation Authority 2008). Some offer significantly more, with five offering more than 300 investment options to their members. However, most individuals choose the default investment strategy of the fund.

Research suggests many Australians find financial investment and superannuation difficult to understand. Further, evidence of low levels of financial literacy is widespread, particularly among specific demographic groups, such as those with low levels of formal education.

Individuals with little knowledge of basic financial concepts often exhibit inadequate personal financial management, including poor borrowing behaviour and a failure to plan for retirement. These individuals may also be more likely to use financial products to bring forward expenditure, on the basis that the debt can be paid by their superannuation. This strategy can significantly affect their future income.

Submissions promote financial advice as a way to improve retirement outcomes and propose making this more affordable through tax concessions. Broader education may also be effective in making it easier for individuals to make the best choices for their retirement.

The effect of superannuation concessions on decisions

The removal of tax on most superannuation benefits has simplified the taxation of benefits. However, situations remain where individuals make decisions they believe are correct but do not provide the best result.

Individuals can make before and after-tax superannuation contributions. Before-tax contributions are deductible while after-tax contributions are not deductible, but may be eligible for the government superannuation co-contribution. This distinction can make it difficult for individuals to decide how best to make additional contributions.

For example, an individual who has a total income of $40,000 a year from wages and wants to make a contribution of $1,000 should invest around $678 as an after-tax contribution and the rest as a before-tax contribution (for example, as salary sacrifice) to maximise the concessions available to a contribution of this size. Deciding whether it is worthwhile to split contributions with a spouse can also complicate retirement planning.

Decisions in retirement

For many individuals, retirement is the first time they will have their financial affairs considered by Centrelink and the ATO. One submission questions why retirees must give similar information to the ATO if this has already been given to Centrelink. Others suggest streamlining the roles of these organisations for retirees.

Notwithstanding the tax exemption for superannuation benefits, many individuals aged 60 years or older still lodge a tax return in respect of their other income. One submission outlines the complexities of the pensioner tax offset. This offset is calculated using many variables, including whether the pensioner is single, widowed or separated. The submission goes on to say that couples need to consider if one is in a nursing home, whether they are a veteran, war widow or war widower, whether they have lived apart due to illness, whether their taxable income is more or less than a specified amount and whether any unused tax offset can be transferred to their spouse.

Individuals must satisfy age, residence and means test requirements to receive the Age Pension. They must also meet proof of identity requirements. Detailed information is sought from applicants to establish whether they meet these rules, which are administered by Centrelink.

Couples are jointly assessed under the means test. Applicants without previous contact with the social security income support system may be unfamiliar with the income and assets test rules. The complexity of an individual's or couple's circumstances largely determines the complexity of the claims process.

Some individuals claim the Age Pension when they reach Age Pension age. Many transfer from another income support payment such as Newstart. Some claim the Age Pension after they reach Age Pension age, for example because their income and assets have decreased to a level that allows them to access the Age Pension.

After an Age Pension is granted, individuals must advise Centrelink, generally within 14 days, of changes in their financial and other circumstances that may affect their entitlement. These are ongoing notification requirements, unlike requirements in the tax system, which are largely confined to annual reports about the previous financial year. The social security notification requirements ensure an individual's assessed income and assets are adjusted quickly in response to changes in circumstances, thereby ensuring their pension rate reflects their current need.

Consultation question

Q5.1 In what ways does the retirement income system impose undue complexity and cost on retirees and workers? How could this complexity be reduced?

6 A sustainable retirement income system

The challenges of an ageing population increase the focus on the effectiveness and sustainability of Australia's retirement income system. The cost of the Age Pension will increase with a rise in the number of individuals aged 65 years or older and their average life expectancy. A sustainable system would support private incentives for retirement saving. These factors highlight the need for an appropriate level of integration between the Age Pension and superannuation.

It is desirable to ensure that retirement income policy is sustainable and does not add significantly to long-run budget pressures. The cost of the retirement income system can decrease the ability of the government to pursue other programs designed to improve the economy and the outcomes for individuals. The ageing of the population also increases the need for the retirement income system to detract as little as possible from economic growth.

Summary of key messages from submissions

Some submissions express concern that the current concessional taxation of retirees will make it difficult for future governments to sustain increases in the Age Pension. Others consider the current arrangements to be appropriate, given the need to encourage voluntary saving and to compensate individuals for having their compulsory savings locked away for retirement.

Several submissions recommend gradually increasing the Age Pension age to reflect increases in life expectancy. Others disagree and argue an increase in the Age Pension age is unwarranted in Australia's retirement income system, as its costs are lower than in other countries.

Many submissions discuss the need to increase the incentives for older Australians to remain in the workforce. They propose changes to policies including: exempting earned income from tax and the Age Pension income test; providing an actuarially fair deferred Age Pension; increasing the Age Pension and superannuation access ages; increasing the generosity of the Pension Bonus Scheme; and improving the skills of older workers.

Some submissions propose accelerating the increase in the age individuals can access their superannuation. This may defer their decision to retire and increase superannuation savings, resulting in fewer full-rate Age pensioners and making the Age Pension more sustainable.

Some submissions propose alternatives to the current means testing arrangements. One proposes having a level of exempt assets then requiring individuals with assets above this level to use them before becoming eligible for an Age Pension. These assets would include the value of owner-occupied housing above $1 million. Another suggests having more generous arrangements for individuals aged 80 years or older.

The Age Pension

While many factors will impact on the long-term sustainability of the Age Pension, the most significant are:

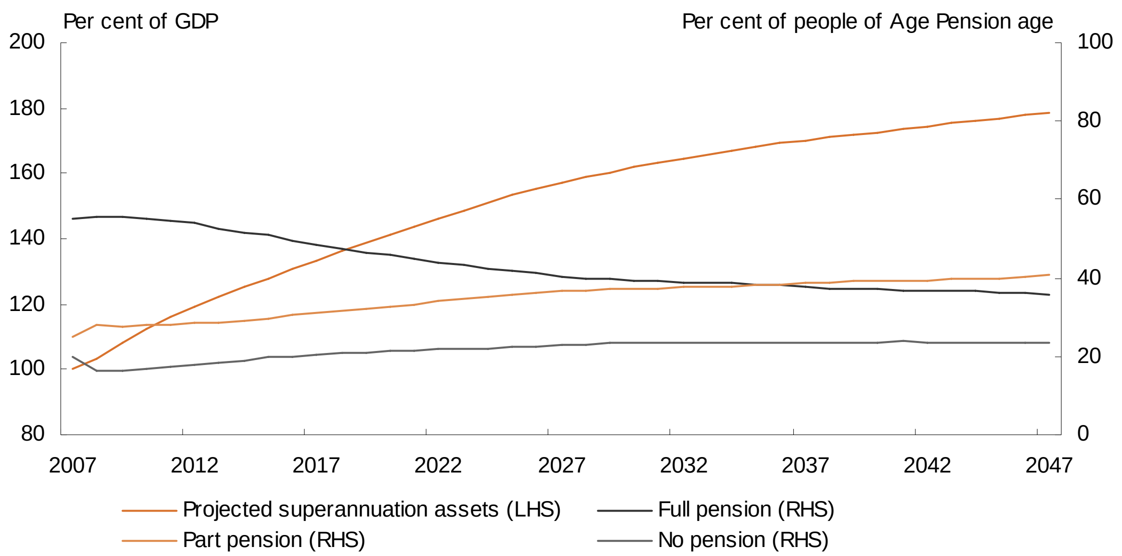
- the ageing of the population;
- dependency ratios and considerations about intergenerational equity;
- pension design; and
- means testing arrangements.

The ageing of the population

The projected increases in the proportion of the population aged 65 years or older, and life expectancy, will increase the number of individuals potentially eligible for the Age Pension and the period they might be eligible to receive it. An increase in the projected value of individuals' superannuation and other assets is expected to only partly offset the effect of demographic change by reducing the proportion of younger Age pensioners.

Under current policy, the proportion of pensioners receiving the full Age Pension is projected to decline, while the proportion with a part Age Pension is projected to increase. Chart 6.1 shows that the proportion of older Australians ineligible for the Age Pension is projected to rise by 3 to 4 per cent, with 77 per cent of older Australians still projected to receive some level of Age Pension. Consequently, Age Pension expenditure is expected to grow from 2.5 per cent of GDP in 2006-07 to 4.4 per cent by 2046-47.

Chart 6.1: Superannuation and Age Pension coverage

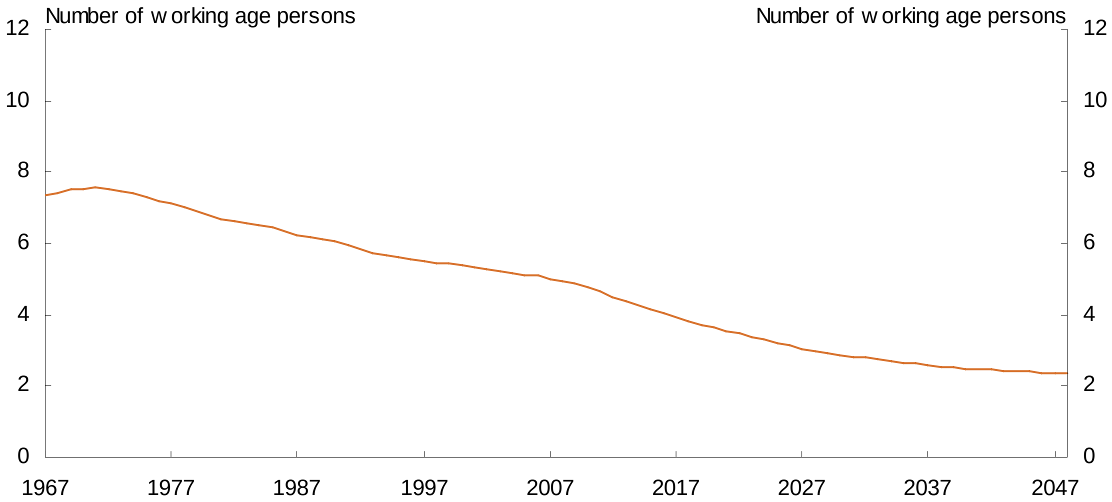


Source: Australian Government (2007).

Dependency ratios and considerations about intergenerational equity

Currently there are five individuals of working age for each individual aged 65 years or older. It is projected that by 2047 there will only be 2.4. Chart 6.2 shows how the number of individuals of working age per person aged 65 years or older is projected to change over time.

Chart 6.2: Number of working-age individuals per individual aged 65 years or older



Source: Australian Government (2007).

The increasing dependency ratio could potentially increase the tax burden on the working-age population to support existing government programs, including the Age Pension. This will be influenced in part by the growth in the real income of Australians and its distribution between working-age and older Australians. If the distribution remains constant, the incomes of those in the labour force would be expected to increase.

This raises a question about the extent to which current and future generations of workers should support older generations. This is important in considering pension benchmarks and the extent to which Age pensioners share in improvements in community standards of living through pension increases. Ageing also adds to other costs, such as health care and pharmaceuticals, which increase as individuals age.

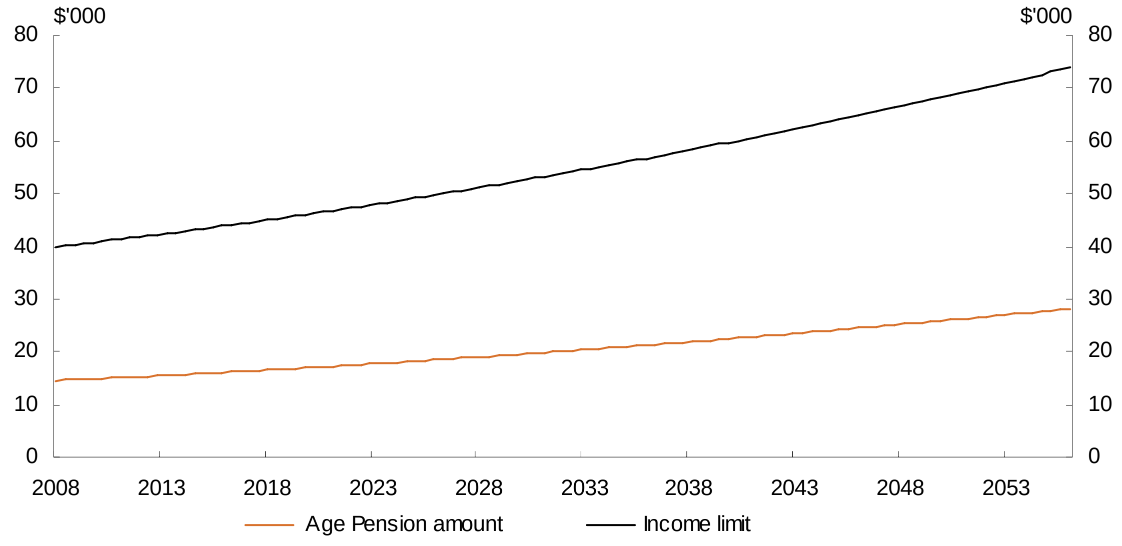
Age Pension design

The design of the Age Pension significantly influences its sustainability. The balance between its role as a safety net and as a retirement income supplement affects the costs of the Age Pension. For a given budget allocation, an Age Pension paid to individuals further up the income scale lowers the maximum rate of Age Pension. Increases to the Age Pension also become more expensive because the total amount of the increase flows on to those receiving a part pension.

Other design issues of importance to sustainability include: the type of indexation arrangements (that is wage or price indexation); the age when individuals can access the Age Pension; and eligibility for other services and concessions available to Age pensioners.

Over time, indexing the Age Pension to male total average weekly earnings will increase its value in real terms. Currently the single rate Age Pension is $14,765 a year. In 2057, the value of the Age Pension will be $28,310 (in today's dollars). The income limit for a part Age Pension will increase from $40,501 to $74,312 by 2057. Chart 6.3 shows how the rate of Age Pension and the income limit is projected to increase over time.

Chart 6.3: Age Pension amount and income limit over time[a]



(a) In 2008 values.
Source: Australian Treasury projections.

Some submissions raise the need to increase the Age Pension age, given increases in longevity. The Age Pension age has been 65 years since it began in 1909. In the 1901-10 life tables, the life expectancy at age 65 years was 11.3 years for a male and 12.9 years for a female. Based on the 2004-06 life expectancy estimates, this has increased to 18.5 years for a male and 21.6 years for a female. A proposal in submissions to address this issue is to link the Age Pension age to increases in longevity. This would reduce the costs of financing the Age Pension by those able to work, and, if combined with an increase in the access age for superannuation, ensure the draw down period does not increase as life expectancies increase.

Other submissions suggest the need to increase the Age Pension age is not as great as in other countries, given the lower costs of our Age Pension. One submission states that the increase in life expectancy has not been matched by an increase in the quality of life of many individuals. These individuals are still likely to need to be assisted by other income support payments. Any increase would need to be phased in so individual retirement plans can be accommodated.

The means tests

Means tests are the primary way in which the Age Pension is targeted as a safety net. They also determine the amount of support the Age Pension provides to those with private income and assets.

Means testing comprises an income test and an assets test. The income test withdraws the Age Pension at a rate of 40 cents per dollar of income above the free area ($138 per fortnight for singles, $240 per fortnight for couples), which is generous by OECD standards. The assets test withdraws the Age Pension at a rate of $1.50 per fortnight for every $1,000 in assets above the threshold (which differs for singles and couples, as well as between home owners and non-home owners). The test resulting in the lowest rate of Age Pension determines the pension paid.

At the current pension rates, means test free areas and taper rates, a couple can have income up to $67,650 per year and assets up to $873,500 (in addition to their family home which is exempt from means testing) and still receive a part pension and a range of other concessions and services.

The structure of means testing is based on a number of principles:

- the income test assumes that the need of a person for support from the Age Pension can be determined by their level of income;
- the assets test is designed to ensure that individuals who have substantial assets (that produce low levels of income) use their assets to support themselves in retirement.
- the combined operation of the two tests targets payments based on need.

The basis of these assumptions for superannuation are less clear. Unlike other savings, superannuation is used by individuals to save income during their working life for use in retirement. As a consequence, as reflected in annuities, a superannuation 'income stream' comprises both earnings on the asset and withdrawals of capital.

Means tests reduce the cost of the Age Pension. However, these tests increase effective tax rates, which affects people's decisions to work and save. The setting of the means tests should therefore reflect the effect they have on these decisions. Increasing means testing will only improve the sustainability of the Age Pension if it has lower efficiency costs than raising tax revenue to fund the Age pension.

Alternative means test arrangements

The Age Pension and superannuation systems are intended to have complementary roles but they were developed and operate largely in isolation of each other. As illustrated in Table 1.2, under current settings an individual with private earnings of two and a half times AWOTE will derive some 15 per cent of their retirement income from the Age Pension, even with a fully mature superannuation system. The need to examine whether to better integrate the Age Pension and superannuation systems raises wider issues about the social security means test.

The social security means test aims to ensure that Age pensioners use their assets productively and therefore decrease their need to call on the taxpayer for support. This approach underpins the 'deeming' rules used to assess the income from financial assets such as shares and bank accounts. Under this approach, a standard rate is applied to customer's financial assets irrespective of the amount that is actually earned.

This approach could be extended, for example, by deeming an income flow from most superannuation assets. This would enhance targeting of the Age Pension to those with the least means, while preserving the capacity of individuals to draw upon their superannuation savings in a flexible way. An alternative approach would be to design the means test to encourage not only the productive use of assets, but the draw down of assets over the course of an individual's retirement.

A further consideration is whether the income test and assets test could be merged into one. This might be achieved through a single income test which deems income on all assessable assets, or through a single assets test similar to that recommended in submissions. Related to this is the issue of whether the means test taper rates should be flat or progressive.

Financial products and the retirement income system

While individuals cannot borrow directly against their superannuation, they could receive a loan on the basis that this can be repaid with their superannuation. This behaviour limits the effectiveness of the retirement income system, as it converts intended future consumption into current consumption. Such a strategy would reduce retirement incomes and reduce the effectiveness of policies to limit access to superannuation, as well as the rationale to give superannuation tax concessions to support future consumption.

A comparison by the Australian Treasury of the Australian Bureau of Statistics' Survey of Income and Housing from 1995-96 and 2005-06, shows more seniors (individuals aged 55 years or older) are carrying mortgage debt later in life. This debt also tends to be larger, both in real terms and as a proportion of the value of the underlying house. The proportion of individuals in this age group who were still paying off their mortgage more than doubled, from 7 to 15 per cent over the 10 year period. The proportion of seniors with a mortgage less than $50,000 fell from almost 70 per cent to less than 40 per cent, while the proportion with mortgages over $200,000 rose from 3 per cent to 16 per cent.

Workforce participation by older workers

Retirement income systems have a range of incentive effects including on workforce participation. The ageing of Australia's population places greater focus on how the retirement income system affects individuals' decisions to participate in, or leave the workforce, especially for individuals of working age.

There are three main groups whose participation decisions could be influenced by changes to retirement income policy settings. The first is those individuals who may have retired but may be willing to return to the workforce. The second is those individuals who use the system to retire earlier than might otherwise have been possible. The third is younger members of the workforce whose participation may be affected by the level of tax on their earnings. Each group is likely to respond to different aspects of the system.

The majority of individuals currently aged 65 years or older have already left the workforce and may be receiving an Age Pension and/or income from their superannuation. For those wanting to participate, the returns from work have increased in recent years due to the senior Australians tax offset and increases in the low income tax offset, in conjunction with the tax exemption of superannuation benefits. Submissions argue that exempting earned income from the Age Pension income test would further reduce disincentives for older Australians to continue working.

In 2007-08 around 27 per cent of men aged 65 to 69 years and 6 per cent of men aged 70 years or older are in the workforce. Eleven per cent of women aged 65 to 69 years and 2 per cent of women aged 70 years or older participate in the workforce. These rates are projected to increase slightly over coming decades based on current policies.

The second group may be responsive to policy changes that affect when they can access their superannuation. In 2007-08 around 78 per cent of men aged 55 to 59 years and 58 per cent of men aged 60 to 64 years were participating in the labour force; while around 61 per cent of women aged 55 to 59 years and 36 per cent of women aged 60 to 64 years were doing so. Australian Treasury projections indicate that participation rates for these age groups may increase significantly over the coming decades.

Of men aged 60 to 64 years, those not in the workforce due to ill health or disability comprise 30 per cent. Those performing home duties or caring for children, an ill person or a disabled person comprise over 13 per cent, while retirees comprise 41.5 per cent (ABS 2006). Of women aged 60 to 64 years, those not in the workforce due to ill health or disability comprise over 10 per cent. Those performing home duties or caring for children, an ill person or a disabled person comprise 47 per cent, while retirees comprise just over 30 per cent. Removing disincentives to work for individuals within this age group could delay their retirement decisions or encourage them to re-enter the workforce.

Policies to encourage greater workforce participation by older workers need to consider the potential impacts on younger workers' decisions to participate. For example, a universal Age Pension would remove the work disincentives of current Age pensioners who are concerned their work income will reduce their Age Pension. However, if the cost of the Age Pension were to result in higher personal tax rates, this may reduce participation incentives for both older and younger workers. Although the consequential disincentives may not be as strong for younger workers as they are for older workers, the larger number of younger workers facing disincentives could result in an overall negative impact on participation.

Pension Bonus Scheme

The Pension Bonus Scheme was introduced on 1 July 1998. It provides an incentive for older Australians to defer claiming the Age Pension and remain in the workforce. The scheme pays a tax-free lump sum to registered members when they eventually claim and receive the Age Pension.

The scheme's rules include that an individual must be registered in the scheme, must meet the work test requirements for each year of deferral, and claim the Age Pension and the bonus within 13 weeks of failing to meet the work test. An individual is not eligible for a pension bonus if the individual receives any Age Pension or any other income support payment, other than Carer Payment, after reaching Age Pension age. Some individuals may be better off receiving a part-rate pension and concessions while they continue to work.

As at November 2008, the maximum bonus an individual could receive is $34,344.30 (single) and $28,686.50 (each member of a couple). This is based on an individual receiving a full-rate Age Pension after having completed a full five years in the scheme.

Consultation questions

Q6.1 The Age Pension serves two roles, as a safety net for individuals who are unable to sufficiently save for their retirement and as an income supplement for many individuals who do save. What should be the role for the Age Pension and means testing in a future retirement income system and what impact does this have on its sustainability into the future?

Q6.2 In what ways does retirement income policy affect workforce participation decisions and what, if any, changes might reduce disincentives to work? Does the sustainability and cost of the retirement income system affect the workforce decisions of younger generations of workers?

Q6.3 What impact could financial intermediation have on the effectiveness of retirement income policy?

Appendix A: Terms of reference

Objectives and scope:

1. The tax system serves an important role in funding the quality public services that benefit individual members of the community as well as the economy more broadly. Through its design it can have an important impact on the growth rate and allocation of resources in the economy.

2. Raising revenue should be done so as to do least harm to economic efficiency, provide equity (horizontal, vertical and inter-generational), and minimise complexity for taxpayers and the community.

3. The comprehensive review of Australia's tax system will examine and make recommendations to create a tax structure that will position Australia to deal with the demographic, social, economic and environmental challenges of the 21st century and enhance Australia's economic and social outcomes. The review will consider:

    3.1. The appropriate balance between taxation of the returns from work, investment and savings, consumption (excluding the GST) and the role to be played by environmental taxes;

    3.2. Improvements to the tax and transfer payment system for individuals and working families, including those for retirees;

    3.3. Enhancing the taxation of savings, assets and investments, including the role and structure of company taxation;

    3.4. Enhancing the taxation arrangements on consumption (including excise taxes), property (including housing), and other forms of taxation collected primarily by the States;

    3.5. Simplifying the tax system, including consideration of appropriate administrative arrangements across the Australian Federation; and

    3.6. The interrelationships between these systems as well as the proposed emissions trading system (ETS).

4. The review should make coherent recommendations to enhance overall economic, social and environmental wellbeing, with a particular focus on ensuring there are appropriate incentives for:

    4.1. workforce participation and skill formation;

    4.2. individuals to save and provide for their future, including access to affordable housing;

    4.3. investment and the promotion of efficient resource allocation to enhance productivity and international competitiveness; and

4.4. reducing tax system complexity and compliance costs.

5. The review will reflect the government's policy not to increase the rate or broaden the base of the goods and services tax (GST); preserve tax-free superannuation payments for the over 60s; and the announced aspirational personal income tax goals.

6. The review's recommendations should not presume a smaller general government sector and should be consistent with the Government's tax to GDP commitments.

7. The review should take into account the relationships of the tax system with the transfer payments system and other social support payments, rules and concessions, with a view to improving incentives to work, reducing complexity and maintaining cohesion.

8. The review should take into account recent international trends to lower headline rates of tax and apply them across a broader base, as well as domestic and global economic and social developments and their impact on the Australian economy.

9. The review will also incorporate consideration of all relevant tax expenditures.

Composition and consultation

10. The review panel will be chaired by the Secretary to the Treasury, Dr Ken Henry AC and will also comprise Mr Greg Smith (Australian Catholic University); Dr Jeff Harmer (Secretary of FaHCSIA), Heather Ridout (Australian Industry Group), and Professor John Piggott (University of New South Wales).

11. The review panel will be supported by a working group from within the Treasury, with representation from the Department of Families, Housing, Community Services and Indigenous Affairs, and drawing on other Australian Government and state agencies as appropriate.

12. The Chair may task members of the review panel to oversee programs of work related to their field of expertise.

13. The review panel will consult the public to allow for community and business input.

14. The review will also, where necessary, draw on external expertise and shall have the co-operation of State Governments and their Treasuries as well as relevant COAG working groups.

15. The Minister for Families, Housing, Communities Services and Indigenous Affairs will provide input on issues related to transfer payments, family assistance and retirement incomes.

Structure and timing

16. The review process will be conducted in several stages. These will follow the release of an initial discussion paper by Treasury on the architecture of the tax system and an examination of the existing tax rates and bases (excluding the GST). The paper will be released by the end of July 2008.

17. The review panel will provide a final report to the Treasurer by the end of 2009. The Government will respond in a timely way to the tax review's recommendations as they are released.

Appendix B: A history of superannuation

The retirement income system

Superannuation was first paid in the mid-1800s as a benefit to certain employees of the public service and larger corporate organisations. Before the introduction of award superannuation in 1986, it is estimated that approximately 40 per cent of individuals were paid superannuation.

The first age pensions were paid by New South Wales (1900), Victoria (1900) and Queensland (1908). A national Age Pension system replaced these schemes from 1 July 1909. The first Age Pension was a modest means tested payment, which was worth around 12 per cent of male total average weekly earnings.

In 1915, the first concessions for superannuation were introduced (with the introduction of income tax), comprising tax deductibility for employer contributions and an exemption of superannuation fund earnings from tax.

Until 1986, Australia had a two pillar system comprising the Age Pension and voluntary savings. Individuals who were not paid superannuation by their employers had to save if they wanted an income above the Age Pension, and were encouraged to do so with superannuation tax concessions. The first compulsory retirement saving scheme begun in 1986, when industrial awards required individuals to have 3 per cent of their remuneration paid as superannuation contributions. The SG extended compulsory superannuation to all employees from 1992 (with some exemptions such as employees earning less than $450 a month and those of certain age).

The taxation of superannuation

Until 1983, only 5 per cent of a lump sum benefit was included in assessable income and taxed at personal rates. In contrast, all income from an income stream was taxed at the individual's personal tax rates (with an exemption for contributions made from after-tax income).

Reforms to the taxation of superannuation benefits were introduced in 1983. The taxation of lump sum payments was raised to 15 per cent for amounts below a specified threshold, and amounts above this threshold were taxed at 30 per cent. Contributions and earnings remained untaxed and the taxation of income streams was largely unchanged. The reforms were applied to service after 1 July 1983, while the pre-1983 arrangements were 'grandfathered'.

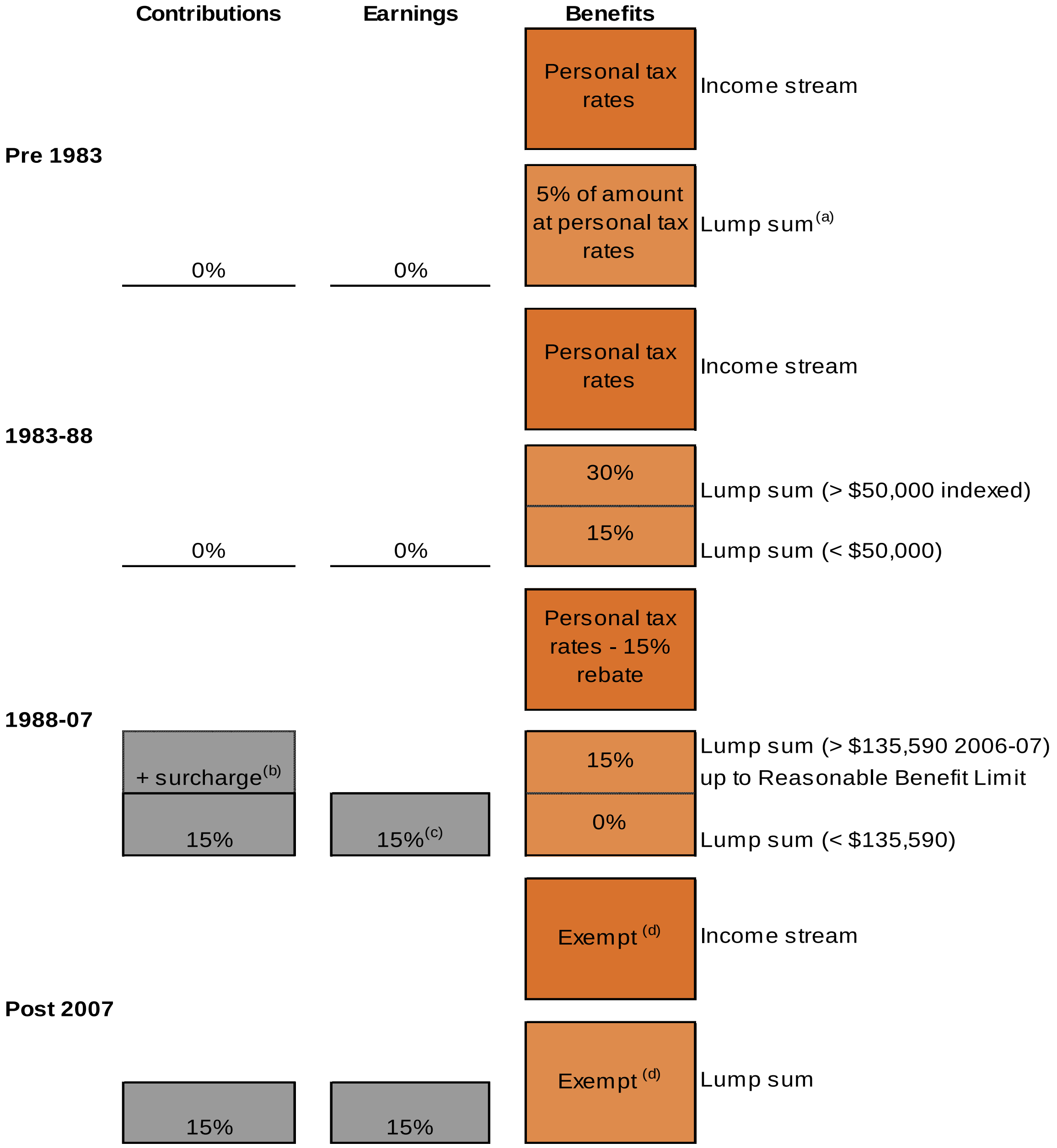
Further revisions to the taxation of superannuation were announced in 1988, when a 15 per cent tax rate was applied to the contributions and earnings of superannuation funds. To compensate for these changes, the government reduced the tax on lump sums to zero for amounts up to the threshold and 15 per cent for amounts above it. Higher amounts of tax applied if a benefit was greater than the reasonable benefit limit.

Income streams continued to be taxed at personal rates. However, a 15 per cent rebate was introduced to compensate for the tax paid during the accumulation of the benefit. The income earned on assets supporting the income stream remained exempt in the fund, as they were taxed at personal rates once paid to the individual.

In 1996, the superannuation surcharge was introduced to reduce the disparity between the concessions provided to low-income and high-income earners. The surcharge added an additional amount of tax on contributions made by or on behalf of higher income earners. The surcharge was abolished in 2005.

Since 1 July 2007, superannuation benefits have been tax-exempt when paid to an individual aged 60 years or older. Benefits are still taxed when taken before this age, or when paid from a fund which has not paid tax on its contributions and earnings.

Chart B.1: History of the taxation of superannuation



(a) This resulted in an effective tax rate no greater than 3 per cent depending on the individual's personal tax rate.
(b) The surcharge applied between the 1997-98 and 2004-05 income years.
(c) Earnings on income stream assets were exempt. Capital gains are taxed at an effective rate of 10 per cent.
(d) Different rates apply to people who take their benefits before age 60 years and payments from funds that have not paid tax on their contributions and earnings.

Appendix C: World Bank multi-pillar retirement income system

The World Bank has recommended a multi-pillar retirement income system including a guaranteed government pension plus a mixture of compulsory and voluntary saving. Holzmann and Hinz (2005) propose the following multi-pillar framework for retirement income systems.

- A non-contributory pillar: provided by government to deal with poverty alleviation.
- A mandatory first pillar: a contributory pension linked to pre-retirement income financed from government revenue.
- A mandatory second pillar: a fully funded individual savings account.
- A voluntary third pillar: discretionary savings which provide greater flexibility than exists in mandatory pillars.
- A non-financial fourth pillar: access to informal support (such as family support), social programs (health care and housing) and other individual financial and non-financial assets (such as home ownership and reverse mortgages).

The World Bank considers that a retirement income system should incorporate as many of these elements as possible. However, it states this should depend on the preferences of individual countries. Australia has all these elements except for the mandatory first pillar, which is equivalent to a social insurance model.

Appendix D: Measures of retirement outcomes

Replacement rates

Replacement rates compare an individual's spending power before and after retirement. The proposition underlying the replacement rate concept is that an individual's standard of living in retirement should be a reasonable proportion of their standard of living during their working life.

Replacement rates can be calculated for an individual or compared with an income benchmark. The appropriate type of replacement rate will depend on how much of an individual's retirement income is made up of the Age Pension.

If an individual has a greater reliance on the Age Pension, a more appropriate comparison is between the Age Pension and the net income of a worker on the minimum or average wage. The Pension Review will consider this issue.

Where the individual has spent a long period in the workforce and has saved during that period, their level of expenditure before and after retirement is a more relevant comparison.

Replacement rate methodologies

Replacement rates can be calculated using a range of methodologies, which can generate a range of results. Differences between results can, in turn, affect the assessment of retirement income system outcomes. For example, a replacement rate based on income before tax may underestimate the effectiveness of the retirement income system, especially where retirees pay less tax than when they were working.

Replacement rate projections can be significantly affected by the period taken into account in their calculation. This can be either the spending in the first year of retirement or an average over a certain period. Table D.1 shows how the period of expenditure in retirement compared to expenditure in the last year of working can affect replacement projections.

Table D.1: Effect of retirement expenditure period on replacement rates

Income as a proportion of AWOTE[(a)]	Average over retirement/last year work %	First 10 years retired /last 10 years work %	First 5 years retired/ last 5 years work %	First year retired/ last year work %
0.75	79	87	84	82
1	68	78	74	71
1.5	56	66	63	60
2.5	51	61	57	55

(a) AWOTE is approximately $1,150 a week.
Source: Australian Treasury projections.

Budget standards

Budget standards are another way of measuring the outcomes of the retirement income system. They involve developing detailed household budgets that specify the items a household needs to achieve a particular standard of living. However, budget standards can be controversial. For example, a standard of living may meet the needs of some households but be insufficient or excessive for others. As such, value judgments play an important part in the establishment of a budget standard. For this reason there will always be an element of controversy surrounding the standard.

Budget standards based on survey data are affected by what items are included in the basket of goods and services. For example, in some standards the budget can include all items that 50 per cent of the surveyed households would consume. However, in reality, the majority of the population may choose between these items. Including all these items it the budget will overestimate the standard. The circumstances of the assumed household will also affect whether the standards are applicable to other groups. For example, a standard based on a home owning household is unlikely to be relevant to a household that rents.

Budget standards lose relevance if they are not regularly updated for inflation and the items included in the budget. Over the medium to long term the standard needs to be adjusted to account for changes in consumption trends and community living standards.

Wellbeing

Replacement rates and budget standards only seek to assess the effectiveness of the retirement income system on the income it provides. They do not capture the value a retiree places on not having to work (that is, leisure) and other services they may receive. Wellbeing measures look beyond income and explore how retirees perceive their retirement.

Retiree wellbeing is more complicated to measure then replacement rates or budget standards. The Household Income and Labour Dynamics in Australia survey (2004) asks retirees about their wellbeing with the last results released in 2004. The Melbourne Institute is currently updating this survey on retiree wellbeing. However, these results are not currently available.

Appendix E: Assumptions used in this paper

The Treasury uses two models, RIMHYPO and RIMGROUP, to measure the outcomes of the retirement income system. The tables in this paper show replacement rates over time and for different income earners. All tables except Table 2.3 are calculated using RIMHYPO, while Table 2.3 is based on RIMGROUP.

The RIMHYPO model takes an individual or couple from workforce entry to death. All relevant combinations of life events, government policies and retirement income sources can be modelled. This model captures in detail the legislative structure defining the interactions between superannuation, taxation and social security legislation. Assumptions in RIMHYPO are:

- current wages indexed at 4 per cent per annum;
- fund earnings of 7 per cent;
- inflation of 2.5 per cent;
- male retiring in 2040 at age 65 years, with a 35 year working life beginning in 2005;
- based on the average expenditure over the entire 23 year retirement period (being from retirement to life expectancy with death occurring on turning 88 years of age on the 1st of July 2063); and
- the superannuation balance is completely invested in an allocated pension, which is drawn down half way between the minimum and maximum factors that existed in the *Superannuation Industry (Supervision) Regulations 2004*.

RIMGROUP is a comprehensive cohort projection model of the Australian population which starts with a population and labour force model, tracks the accumulation of superannuation in a specified set of account types, estimates non–superannuation savings, and calculates tax payments and expenditures, social security payments including pensions and the generation of other retirement incomes. These projections are done for each year of the projection period separately for each birth year gender decile cohort.

Table 1.1: Replacement rates for an individual aged 60, 40 and 20 in 2008 who retires at age 65 years

An individual age 20 years in 2008 will receive SG for 45 years, while an individual aged 40 years or 60 years in 2008 has received SG since 1992.

Table 1.2: The changing retirement income system

The cameos are for a male who retires at age 65 years who has received SG since 1992. The male retiring in 2040 began receiving SG in 1995 when he was 20 years old.

Table 2.1: Replacement rates based on income — using CPI discount

Various replacement measures for a single male with a 35 year working life, retiring in 2040. Only compulsory SG contributions are made for all hypothetical cases presented.

Table 2.2: Replacement rates based on income — using wages discount

As for Table 2.1, except the results are deflated by wages instead of CPI.

Table 2.3: Aggregate replacement rates

The rates are calculated on an average basis for this entire population. They also take into consideration the various retirement ages and workforce participation of individuals within this group.

Table 3.1: Effect of increasing compulsory saving on replacement rates

The figures shown in Section 3 are deflated by CPI. Table E.1 shows the results if deflated by wages.

Table E.1: Replacement rates deflated by wages

Saving rate	AWOTE(a)			
	0.75 %	1.0 %	1.5 %	2.5 %
9 per cent SG	65	56	47	40
12 per cent SG	70	61	52	46
15 per cent SG	73	65	56	50

(a) AWOTE is approximately $1,150 a week.
Source: Australian Treasury projections.

Changes to assumptions

Replacement rates are sensitive to the assumptions used in their calculation. Table E.2 shows how changing the assumptions made on life expectancy, years in the workforce and investment returns change the projected replacement rate of 79 per cent (based on the standard assumptions) for an individual earning 75 per cent of AWOTE.

Table E.2: Effects on replacement rates using different assumptions

Change in assumption	Replacement rate %
Life expectancy (-3 years)	81
Life expectancy (+3 years)	77
Working life (-5 years)	74
Working life (+5 years)	84
Investment returns (-1 per cent)	75
Investment returns (+1 per cent)	83

Source: Australian Treasury projections.

This analysis is based on a male who retires in 2040 at the age of 65 years. He earns 75 per cent of AWOTE each year and has a 35 year working life as the base case. The base life expectancy used is 87 years. Investment return differences apply in each year of both accumulation and retirement phases.

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