SUBMISSION TO RETIREMENT INCOME REVIEW

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BACKGROUND

We were foundation members of the Committee for Sustainable Retirement Incomes (CSRI), a non-aligned group of respected policy advisers who agreed to work on a voluntary basis with experts and practitioners to develop a coherent set of policies to ensure Australia's retirement incomes system is both effective and sustainable.

With support from the Academy of the Social Sciences in Australia we organised a series of workshops in 2016 to explore three key aspects of the retirement incomes system:

1. Adequacy
2. Sustainability and Self-provision
3. Post-retirement incomes.

Each workshop was informed by papers we commissioned from experts, and by recent research. The workshops led to CSRI Position Papers circulated widely for consultation ahead of a national leadership conference in October 2016, with an overview summary of recommendations. A list of most of the documents prepared for and drawn upon by the CSRI at the time is at Attachment A. We can locate copies if the Review is interested. Some papers were in draft and permission by the authors to cite them would be needed.

The CSRI continued work after the 2016 national conference, led by Patricia Pascuzzo. Our involvement diminished as the agenda rightly moved to more technical issues relating to post-retirement products where industry expertise was required.

We firmly believe the work by CSRI in 2016 continues to be highly relevant in terms of setting out an evidence-based approach for a coherent and sustainable retirement incomes system in Australia. This submission draws heavily on that work, updated where possible from our knowledge of more recent developments and research.

RETIREMENT INCOME SYSTEM

Consultation Question 1: Are there aspects of the design of retirement income systems in other countries that are relevant to Australia?

Andrew Podger co-authored an article with Peter Whiteford and David Stanton, published in *Public Administration and Development* in October 2014, which discussed in more detail than in the Review's Consultation Paper the history of the 'pillars' approach to describing and analysing retirement incomes systems, and presented an assessment of the strengths and weaknesses of the emerging Australian model. It was published as part of a symposium of papers on systems in a range of countries (Podger was a co-editor). Particular issues raised in that symposium we would highlight are:

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- The importance of the Foundation Pillar (Pillar 1 in the Review's description of pillars), to protect people from poverty in old age;
- The underlying risks for all retirement income systems whatever their mix of pillars, and the importance of managing these carefully to achieve adequacy, security and sustainability (including inter-generational equity);
- The challenge for governments whose systems rely heavily on social insurance (not included in the Review's pillars) to manage demographic changes and associated financial risks and inter-generational equity;
- The challenge for systems relying more heavily on defined contributions (pillars 2 and 3 in the Review's description) to help individuals to manage the risks they bear, including market and longevity risks, and to understand the complexities involved.

Around the developed world there is increasing emphasis on defined contribution schemes, either mandated or voluntary (pillars 2 and 3), complementing their social insurance schemes, in part aimed at facilitating measures to reduce the financial pressures on those schemes (for example raising eligibility ages).

Around the developing world, there is increasing emphasis on Foundation Pillar (or pillar 1) schemes to alleviate poverty.

Arguably, these international tends point towards the emerging Australian approach, but we have yet to ensure individuals under our approach are able to manage the risks they bear under that approach.

PURPOSE OF THE SYSTEM AND ROLE OF THE PILLARS

Consultation Questions:

2. **Is the objective of the Australian retirement income system well understood within the community? What evidence is there to support this?**
3. **In what areas of the retirement income system is there a need to improve understanding of its operation?**
4. **What are the respective roles of the Government, the private sector, and individuals in enabling older Australians to achieve adequate retirement incomes?**
5. **What should each pillar seek to deliver and for whom?**
6. **What are the trade-offs between the pillars and how should the appropriate balance between the role of each pillar in the system be determined?**

The CSRI favoured the following objective which is broader than the one outlined in the Consultation Paper:

> 'To provide adequate income through all the years of retirement for all Australians in a sustainable way'.

The articulation of the objective in the Consultation Paper is very similar, though the CSRI formulation incorporates the idea of *security* ('all the years of retirement') as well as adequacy. That idea in our view needs more emphasis both in expression and in practice.

Our strong impression is that important aspects of the objective are not widely understood:

- Most significantly, accumulated superannuation savings from pillars 2 and 3 are not widely considered in terms of the retirement income streams they can fund;

- Accordingly, there is little understanding of ‘adequacy’, relating accumulated assets to pre-retirement incomes and living standards;
- There is a lack of understanding of longevity risk and how to manage it (highlighted by the Financial Systems Inquiry), few people appreciating that efficient management of longevity risk requires pooling in one way or another;
- Even Government seems not to think of assets in terms of the income streams they can deliver, over-stating the ‘value’ of superannuation accounts (e.g. setting the assets test cut-out point well below the income test cut-out point in these terms).

It is essential, in our view, to change the language surrounding our retirement income system, as well as to ensue appropriate products are readily available. Regular reporting by funds of members’ accumulated assets should include expected retirement income streams based upon reporting standards set by regulation (e.g. current accumulation plus contributions at current rates, continuing to preservation or age pension age, directed into a CPI-indexed annuity, as a percentage of current earnings (escalated by wages)).

It is also important to address the complexity of the system, presenting all three pillars in terms of secure retirement income streams, and simplifying the means test (and offering tools to help people to model their likely age pension entitlement).

We suggest the following clarification of the respective roles of the Government, the private sector and individuals:

- The Government should fund and deliver means-tested age pensions, sufficient to protect older Australian against poverty; mandate contributions sufficient for adequate levels of income maintenance for those on incomes up to about the median or a little more; and regulate industry to ensure appropriate prudential standards and guide individuals towards savings and retirement income products suited to their general circumstances, helping them to manage the risks they bear;
- The private sector should manage individuals’ savings according to the properly informed choices individuals make, and to regulatory requirements;
- Individuals should be responsible for savings beyond the mandated level to achieve their desired (adequate) retirement income; have choice regarding investment and post-retirement consumption of their savings, but with full information and government-mandated guidance.

We understand that surveys by a number of major funds reveal that the vast majority of people want clear guidance, particularly in the pensions phase, and do not necessarily value the range of choices the system offers them, for fear of mismanaging the risks. They may have some general preferences (e.g. a balance between a regular, secure income stream, capital for early major consumption, savings for security against possible future needs such as residential aged care, and assets for bequests), but do not enjoy exercising more detailed choices.

We suggest the respective roles of the three pillars should be:

- Pillar 1: to protect older Australians from poverty, ensuring at least a modest standard of living relative to community standards, particularly amongst those unable to accumulate savings under pillars 2 and 3 (especially those unable to save for their own home);]
- Pillar 2: to ensure, with any age pension entitlement, an adequate retirement income relative to their pre-retirement standard of living, for those earning up to around median earnings or a little more;

- Pillar 3 superannuation: to facilitate the capacity of those with above median earnings, and those with broken employment, to achieve adequate retirement incomes by supplementing pillar 2 savings;
- Pillar 3 housing: to provide security of shelter, to limit housing costs in old age (reducing the call on their retirement income), to provide security against possible future aged care needs, and to comprise the main source of bequests (though few appreciate the actual value of the bequest involved).

Housing should be able also to finance additional income streams. The obvious way for a retiree to use their house to generate additional cash is to borrow against the house asset i.e. to increase any existing mortgage or to take out a reverse mortgage. The other way would be to downsize and replace the existing dwelling with something cheaper, which would then generate a cash surplus. However, both these ways of accessing additional cash result in a lump sum and there are few products available in which people can then invest to generate a continuing income stream available for the remainder of their lives.

A key trade-off is between pillar 1 and pillars 2 and 3. When pillar 2 was first introduced, the Keating Government saw it mainly as supplementing, not replacing, the age pension, enhancing the retirement incomes of most Australians. Some offset in age pension costs was expected, but until well after 2000, the expectation was that around 80% of Australians of age pension age would continue to be eligible for some age pension. In fact however, there has been a very considerable downward trend in age pension coverage (as shown in Figure 5), with the likelihood in the not-too-distant future of no more than 60% being eligible for some pension, and around 30% only on the maximum rate.

The optimal means test arrangement is not clear (see further below). There would be some advantage from a universal age pension, in terms of simplicity and integration with superannuation, but the cost would be very high. We assume there is no political support for that option. But the means test should provide some reward for working and saving, including from mandated saving. While there is little evidence of the income test having a significant effect on work incentives, there is reason for concern that the assets test taper now leads to lower retirement incomes from increased savings over a wide range of accumulated assets (unless the savings are directed to non-assessable assets).

This raises the question of the relationship between housing assets (in pillar 3) and the pension (pillar 1). Home ownership has a number of benefits for the aged as outlined above, and should complement pillars 1 and 2 (and voluntary superannuation in pillar 3), but beyond some quite high threshold there is a strong case for including the housing assets involved in the means test.

THE CHANGING AUSTRALIAN LANDSCAPE

Consultation Question 7: What are the main impacts of demographic, labour market and home ownership trends? To what extent is the system responsive to these trends? Are there additional trends the Review should consider?

For the most part, the Australian system is well placed for handling demographic change. We do not favour automatic adjustment of the age pension age, but suggest five-yearly reviews in the context of the Inter-Generational Reports. Such reviews could take into account not only shifts in the dependency ratios (population above age pension age and below 18 years divided by the working age population), but also any evidence of varying abilities to continue working, appropriate support

for those not able to continue working, and whether any improvements in per capita GDP might be directed to some increase in years in retirement.

It would also be worthwhile linking the superannuation preservation age to the age pension age (say, five years lower than the age pension age).

The downward trend in home ownership seems likely to flow on to the elderly (though recent projections by Grattan and others may exaggerate the trend if a significant component is delayed access to mortgages, or if in future mature age renters start using bequests from deceased parents to purchase homes). This trend adds weight to the case for greater assistance for low income renters, and for more equitable treatment of renters with home owners under the assets test.

We do not see any particular issue with the apparent trend towards higher mortgages amongst owners at old age, as they still have the balance as an asset.

Trends in the labour market suggesting greater variability in working hours and forms of working add weight to allowing people to 'catch-up' superannuation savings through pillar 3. The current concessional cap for contributions ($25,000) perhaps should be increased, at least for those with low levels of accumulated savings (relative to their current incomes). There is also a case for lowering the threshold below which the SG contribution is not mandated, though this threshold has not been adjusted for some years now.

Trends in the economy present potential problems, particularly regarding the price of indexed annuities (and related products) given the regulators' prudential requirements and indications that real rates of return will remain lower than in the past. As a result, the price of products offering longevity risk protection may remain very high, higher than most retirees consider value for money. Accordingly, proposed Comprehensive Income Products for Retirement (CIPRs) involving longevity risk protection may not be attractive to many in practice despite the in-principle benefits of much greater use of them. Perhaps there are still market failures to address in this area, and a case for the Government to sell indexes annuities at a price set by the Government Actuary.

PRINCIPLES FOR ASSESSING THE SYSTEM

Consultation Questions:

8. **Are the principles proposed (adequacy, equity, sustainability, cohesion) appropriate benchmarks for assessing the outcomes the system is delivering now and into the future? Are there other principles that should be included?**
9. **How does the system balance each of the principles and the trade-offs between the principles under current settings? What is the evidence to support whether the current balance is appropriate?**

We would be inclined to add 'security' to the principles. Security could be considered an element of 'adequacy', but we feel it needs more highlighting.

We support the inclusion of 'cohesion' as a principle, as it underlines the idea of a retirement income 'system' that should be coherent and widely understood. Cohesion is particularly important in the period leading to retirement and in the pensions phase. That is why the CSRI gave so much weight to the question of post-retirement incomes, where the options and available products are poorly developed at present, and have a correspondingly poor take-up rate.

So far as the balance between the principles is concerned, Australia rates very highly on financial sustainability in OECD reports, with the cost of age pensions already very low and not estimated to

increase relative to GDP whereas the costs in other OECD countries are expected to increase sharply from higher bases over the next 40 years.

We believe Australia also performs well against the equity principle, other than in respect of low income renters and people unable to work to age pension age and who rely on Newstart. We do not believe sustainability would be placed in any jeopardy if these concerns were properly addressed. As discussed further below, we do not believe there is any major concern regarding the equity of current superannuation tax arrangements, and we believe the costs to revenue involved are sustainable.

The biggest single challenge in our view concerns 'cohesion', particularly in the pensions phase. This requires the system to present itself in terms of the *secure* retirement income streams it delivers from each of the three pillars and in aggregate.

ADEQUACY

Consultation Questions:

10. **What should the Panel consider when assessing the adequacy of the retirement income system?**
11. **What measures should the Panel use to assess whether the system allows Australians to achieve an adequate retirement income? Should the system be measured against whether it delivers a minimum income in retirement; reflects a proportion of pre-retirement income (and, if so, what period of pre-retirement income); or matches a certain level of expenses?**
12. **What evidence is available to assess whether retirees have an adequate level of income?**

Unlike the CSRI's approach, the Review's Consultation Paper does not have a separate section devoted to 'post-retirement incomes'. Yet this is a critical component of 'adequacy': the way in which accumulated savings are consumed in practice. The fact is that they are not currently translated into secure lifetime income streams, even when in theory they might be 'adequate' for this purpose.

Work done over the last two years within Government on CIPRs is aimed to guide retirees towards turning their accumulated superannuation savings into income streams suited to their circumstances and helping them to optimise their consumption over their retirement years. In most cases, a CIPR would include a form of longevity insurance via an annuity; for some who remain reliant primarily on the age pension, an allocated pension for a set number of years may be appropriate as the age pension provides sufficient protection against longevity risk. As yet, however, CIPRs are not widely offered or used. Too many retirees are either insufficiently protected against longevity risk or, as the Financial Services Inquiry found, inefficiently self-insure and leave more of their savings in their estates than planned.

We strongly recommend the Review investigate why the take-up of annuities remains so low, and what actions might lead to the optimal use of accumulated savings for the purpose of ensuring adequate and secure lifetime incomes.

Turning now to the Review's Consultation Questions, the CSRI considered adequacy against two implied objectives: poverty alleviation and income maintenance.

In terms of poverty alleviation, the CSRI relied heavily on the Harmer Report and work by Peter Whiteford. These suggest that the basic rates of age pension are sufficient for protection from

poverty for those who own their own homes, but that rent assistance is insufficient for those in private rental accommodation. This conclusion is supported by more recent research by the Grattan Institute and CEPAR.

In Whiteford's view, the OECD overstates the level of poverty amongst the aged in Australia because of some technical measurement issues. Indexation of age pensions by wage movements is supported as this appropriately ties the definition of 'poverty' to prevailing community standards. Newstart, however, is now much lower than the age pension and is not indexed to wages, despite the recommendations a decade ago by the Henry Tax Review. It is well below any reasonable standard of poverty though relied upon particularly by people unable to find employment ahead of the age pension age.

Defining adequacy for the purposes of income maintenance is complex. First, there is debate about the denominator – the pre-retirement income base. Grattan uses the income in the years just before age pension age, but this understates the incomes many had achieved as it does not take into account declining rates of employment and hours of work in those last few years before full retirement. Gallagher uses a working life measure, adjusting for movements in real wages over the working life, and using various cameos of working life experiences. It is possible this too understates the living standard reached at the point a couple (or individual) no longer had any dependents and worked full-time. Arguably, the denominator that would best reflect the living standards people would like to maintain is the peak income (of a couple or single) when there are no dependants. Measuring this, however, is a challenge.

Second there is debate about the numerator – the measure of income post-retirement. Grattan assumes that this does not need to increase in real terms over the retirement years, even reducing superannuation by any real increases in age pension eligibility. This is based on evidence of expenditure patterns over retirement, including evidence of some net saving. Gallagher adjusts all retirement incomes by a wages index. Most defined benefit schemes have CPI-indexed pensions, many also providing additional (employee-funded) lump sums that can be used for extra expenditures in the early years of retirement.

The CSRI generally worked on the basis of translating pillar 2 and 3 superannuation savings into CPI-indexed annuities, and retaining wage-indexed pillar 1 age pensions ie more generous than Grattan but less so than Gallagher. Neither Grattan nor Gallagher directly use annuities, but instead used expected lifetimes after age pension age. This is likely to understate the cost of protection against longevity risk, particularly under the Grattan modelling which assumes increasing reliance on the age pension.

Third, there is the benchmark ratio between the denominator and numerator. This should take account of generally lower costs (e.g. mortgage repayments, costs of working) and lower tax. A net income replacement rate of 70% is commonly used (e.g. by the OECD), at least for those around median to average earnings. Arguably the ratio should be lower at higher incomes.

It is also important to take into account wide variations in both pre-retirement and post-retirement experiences and preferences. The CSRI used cameos based on Peter MacDonald's research of common lifetime experiences. Importantly, about 70% of people at age pension age have partners with whom they can be expected to share incomes, assets and expenditures (some literature suggests women have less control over the decisions made, but there is limited evidence of failure to share).

On the basis of the Gallagher modelling using a series of cameos of working lives, family arrangements and different incomes, the CSRI considered that increasing the SG to 12%, as currently legislated, will deliver slightly below the 70% benchmark for those on median earnings, and was appropriate (the Henry Tax Review used this 70% benchmark for incomes up to between the median and the mean).

We recommend, however, that the Review conduct its own examination, drawing on actuarial advice and using a range of typical cameos of working lives and family circumstances, together with carefully considered, explicit assumptions about the benchmark pre-retirement income in each case and the appropriate post-retirement consumption of accumulated savings. We suggest the Review apply a 70% net income replacement rate at retirement for those on around median earnings or slightly above, to assess the optimal SG rate.

If, as the CSRI assessed, the appropriate rate is more than the current 9.5%, care will be needed to phase in the increase to ensure it is appropriately financed with minimal adverse impact on the economy, the budget and the real disposable incomes of employees (noting the phasing in arrangements in the current legislation, and the delay enacted a few years ago). Bearing in mind that this adequacy benchmark concerns those who own their own homes, there is a strong case for giving higher priority to those who do not own their own home by increasing rental assistance before increasing the SG.

Because some age pension would be payable to those on median earnings, it is likely that those on higher incomes should look to contribute more than the SG to achieve an adequate retirement income, even if the adequacy benchmark was below 70% for those on or above average earnings. It would be helpful again, if the Review explored via actuarial advice and a range of cameos the level of voluntary savings beyond the SG that those on average earnings and above should be encouraged to make. Given that superannuation income in retirement is not taxable, and the appropriate benchmark for the net income replacement rate is probably under 70%, it may be that the appropriate total contribution rate is not all that much higher than 12%. Actuarial advice we received in January 2020 from Mercers was that, on average, someone working full-time for 40 years to age pension age (67 years) with a steady income relative to AWE would achieve a CPI-indexed income with a 60% gross income replacement rate (not including any age pension) with contributions of 15.9% (16.3% with a surviving spouse pension); the net income replacement rate at average income or above would however be more than 70%. This suggests that 12% contributions by such a person would achieve a gross replacement rate of 45% (slightly less with a surviving spouse pension) or a net replacement rate of around 60% at average earnings. However, it is likely that higher income earners experience higher than average life expectancy (as is the case of public servants), that most will have careers where final income will be higher relative to AWE than their early career incomes, few will have 40 years uninterrupted earnings, and many will wish to draw on some of their savings before reaching age pension age. More common cameos might provide better guidance for those on or above average earnings as to the most appropriate level of superannuation contributions.

EQUITY

Consultation Questions:

13. **What should the panel consider when assessing the equity of the retirement income system?**

14. **What factors and information should the Panel consider when examining whether the system is delivering fair outcomes in retirement? What evidence is available to assess whether current settings support fair outcomes for individuals with different characteristics or in different circumstances?**
15. **Is there evidence the system encourages and supports older Australians who wish to remain in the workforce past retirement age?**
16. **To what extent does the system compensate for or exacerbate inequities experienced during working life?**
17. **What are the implications of a maturing SG system for those who are not covered by compulsory superannuation?**

There are several dimensions of 'equity' to consider. Australia's reliance on DC superannuation means it achieves inter-generational equity far better than most other countries. The general revenue financed aged pension presents little risk to inter-generational equity, and we have a good record in addressing the risk we have by adjusting the age pension age (and removing wifes pensions, Class B widows pensions etc.). As mentioned above, we suggest further regular reviews of age pension age when IGRs are published.

The age pension ensures generally good protection against poverty, and concentrates assistance on those most in need. It delivers equitable outcomes in terms of direct and immediate support, and is financed through general revenue that includes progressive income tax.

As mentioned on page 17, 'Ideally, the retirement income system should support individuals to save enough to allow consumption smoothing over their lifetime without deferring too much consumption to their retirement at the expense of living standards during working life'. This 'lifetime equity' is assisted by Government support for individuals during their working lives when they face particular pressures, such as through family benefits and childcare assistance, and welfare support. In light of such direct support, we would be reluctant to suggest special relief from the SG in such circumstances, suggesting instead that keeping the SG at a reasonably modest level and applying it throughout individuals' working lives to achieve adequate retirement incomes at and below median earnings is the appropriate policy, providing reasonable equity over lifetimes. We note that the Henry Tax Review suggested the benchmark for the SG should be to achieve an adequate retirement income for those with employment incomes a little above the median.

We do not believe the means test has a major impact on workforce participation. The Harmer Report noted that measures to encourage greater participation by relaxing the test had not proved effective. Other evidence including by the Productivity Commission reviewed by Michael Keating in 2016 for the CSRI similarly suggested the means test had little impact, with people deciding when to cease full-time work and when to apply for the pension for reasons other than the impact of the means test.

We are concerned, however, about the likely impact of the assets test as amended in 2017. The increased taper (above the increased thresholds) means that, over a wide range of assessable assets, a pensioner may have a lower retirement income despite a higher level of assets. There is a strong incentive to direct savings into non-assessable assets such as the home, and it is not at all clear what professional (and ethical) financial advice would be given to someone approaching retirement or at retirement to maximise retirement income and living standards. Perhaps the assets test will encourage some to defer applying for the pension until their assessable assets reach the assets test threshold, then apply for the maximum rate, but this would not be consistent with optimal spreading of lifetime incomes, and it would increase reliance on the pension at older ages.

Andrew Podger and David Knox have been exploring how a merged means test might be designed today, drawing on the principles behind such a test in the 1960s, and encouraging the presentation of pillar 2 and 3 assets as retirement income streams, consistent with the way the age pension itself is presented. In a presentation to the CEPAR annual conference in December 2019 they firmly argue for some relaxation of the assets test taper (their initial work suggests an effective taper of around 3% - applying the income test 50% taper to the indexed annuity value of assessable assets of around 6% at age 67 - but they would not oppose a taper of 4% to encourage actual purchase of annuities). They also canvass options for the threshold that might treat home-owners and renters equitably, and the option of including home assets above a high threshold.

We strongly question the way the Consultation Paper presents the incidence of superannuation tax concessions (Figure 4). This is based upon a benchmark TEE taxation regime for savings. That may be appropriate for most savings, but if the purpose of superannuation is to spread lifetime earnings, then lifetime earnings represents the appropriate base for applying the (progressive) income tax. That implies the benchmark should be EET. A parallel may be the accepted arrangements allowing farmers to spread incomes over good and bad years: compared to the usual annual tax regime, those arrangements not only reduce tax liability but reduce it most for those experiencing the highest incomes in good years. But the system is fair, involves no real concession or tax expenditure let alone one that should be seen to favour the rich. In the case of superannuation, with compulsory vesting and some mandated savings, the case for an EET regime is particularly strong given the period over which the savings are held. It is also the only way to tax DB schemes and, accordingly, is the orthodox approach internationally.

Work commissioned by the CSRI from Phil Gallagher revealed that the current ttE regime (following the tightening in 2016) has a very similar impact on after tax retirement incomes to that of the ideal EET regime at most income levels and for most of the cameos studied. Accordingly, using an EET benchmark, not only would the tax expenditures shown in Figure 4 disappear, but also the apparent regressive impact. Indeed, together with the means-tested age pension, the overall retirement income system would be revealed as quite progressive and equitable.

One issue that is frequently raised, however, is whether the system is fair in its treatment of men and women. This issue was raised in CSRI discussions but no firm conclusion was reached. There continues to be a sharp difference between the accumulated superannuation savings of men and women at the same age, but the data presented (including by Treasury) does not take into account the legal entitlement of married people to a half share of their partners' savings, nor for those who have divorced or separated in the past, any share of their ex-partners' savings they may have received (in the past, it was common for the woman to receive the home assets while the man retained the superannuation, but we understand the law now requires the superannuation to be shared, so that commonly the home assets are also shared). These factors are highly significant given that at age pension age 70% of people have partners and, of the rest, a significant number previously had partners. Equally important in considering this issue is the cause of the different levels of accumulated savings, and how that might best be addressed. In large part the cause is the difference in employment and earnings over the working lives of men and women. Policies which facilitate greater opportunities for women to gain employment and experience equal opportunities for career progression etc. should therefore be the primary focus for addressing the unequal superannuation savings amongst men and women. Nonetheless, as women continue to play the dominant role in care of the elderly as well as of children and in other valuable voluntary work that limit their earnings from employment before age pension age, there is a case for recognising this through government contributions towards superannuation during these periods, as well as for

widening the SG coverage and allowing more ‘catch-up’ after breaks in employment. It is also important to recognise the role of the age pension in protecting women, particularly from longevity risk, and the increasing importance of Newstart for women approaching age pension age (including for those undertaking approved voluntary work) – this is another reason for addressing the inadequacy of Newstart as mentioned above.

SUSTAINABILITY

Consultation Questions:

18. **What should the Panel consider when assessing the sustainability of the retirement income system?**
19. **What factors should be considered in assessing how the current settings affect its fiscal sustainability? Which elements of the system have the greatest impact on its long-term sustainability?**
20. **How can the overall level of public confidence be assessed? What evidence is available to demonstrate the level of confidence in the system?**

The main aspect of sustainability considered by the CSRI was financial sustainability in terms of budgetary costs. Other aspects include that the system does not impose excessive burdens on people in the accumulation phase, that it is widely understood and supported (including that it is not overly complex), that it is stable and not subject to constant policy change (so people can reasonably plan for their retirement) and that it is secure and effectively and efficiently manages risks. Many of these latter aspects are discussed under ‘Cohesion’ below.

So far as fiscal sustainability is concerned, the Australian age pension is remarkably sustainable: the cost in 2015 was 4.3% of GDP, less than in almost any other advanced OECD country and not much more than half the OECD average of 8%. The Parliamentary Budget Office projects no increase in the cost relative to GDP over the next ten years (*2019-20 Medium-Term Fiscal Projections,* Report 03/2019), and the Review itself shows that the cost is not projected to increase significantly as a proportion of GDP in the decades beyond (the Paper’s Figure 5 refers). The changes recommended above to increase rental assistance and to ease the assets test would not impose a large new burden. Other costs of our ageing population such as health and aged care present far greater challenges. Increasing contributions and earnings do involve some cost to the budget notwithstanding the strong case for the current tax treatment involved as discussed above: moving from income taxed on a TEE basis, or savings taxed on a TTE basis, to savings taxed on a ttE basis (that is similar to an EET basis), has immediate revenue implications. But we are not convinced by any means that this represents an excessive cost now or into the future: rather, it is the inevitable consequence of a system that facilitates the spreading of lifetime earnings in an inter-generationally equitable fashion.

The Paper states that the system needs to be able to accommodate demographic and economic trends without requiring a significant increase in government support. Equally, it must do so in ways that are widely understood and that do not unduly disrupt people’s savings and retirement plans. Measures to address demographic and home ownership trends are discussed above. Should investment returns continue at lower levels than in the past, it may be that, eventually, the SG should increase beyond what may seem appropriate right now. Of more immediate concern is the impact of low returns on low risk investments which retirees typically should rely upon. This, together with prudential requirements, is raising the price of annuities significantly (now well over 20 times the indexed annuity), and encouraging retirees to keep more of their savings in higher risk

products and not to address longevity risk properly. It may also exacerbate the problem identified by the FSI of holding onto savings to manage longevity risk, leading to bequests greater than planned and undermining the basic objective of the system.

This last problem (regardless of prevailing investment returns) is best addressed through wider offering of CIPRs including much greater emphasis on annuities in the pensions phase. As mentioned above, we suggest the Review explore the reasons behind the low levels of translation of accumulated savings into annuities or other longevity insurance products. There is also a strong case for some tax penalty on funds in superannuation accounts at death or death of the surviving partner.

COHESION

Consultation Questions:

21. **What should the Panel consider in assessing whether the system is cohesive?**
22. **Does the system effectively incentivise savings decisions by individuals and households across their lifetimes?**
23. **What evidence is available to show how interactions between the pillars are influencing behaviour?**
24. **What is the evidence that the outcomes the system delivers and its interactions with other areas are well understood?**
25. **What evidence is there that Australians are able to achieve their desired retirement income outcomes without seeking formal financial advice?**
26. **Is there sufficient integration between the age pension and superannuation?**

The CSRI considered the biggest challenge for the Australian system was translating the growing superannuation balances into appropriate retirement income products that could be integrated with the age pension. This is the central 'cohesion' issue.

It is of course the pension means test which makes cohesion difficult. A universal pension would allow people to plan their savings for retirement simply as a supplement to the age pension. The means test reduces the pension as savings or other income increases, the formula based on joint not individual savings and income, and with complex rules in separate income and assets tests; those rules are also subject to frequent change. It is very hard therefore for people to be confident about their likely age pension entitlement and hence their overall retirement income. With 60% or more of those of age pension likely to retain some age pension eligibility, this is a huge obstacle to cohesion.

We recognise the benefits of the means test in limiting costs while protecting people from poverty. We also note that there is little evidence to support the idea that the income test adversely affects work behaviour (the evidence seems to point to people deferring retirement and then applying for the pension, rather than working reduced hours and supplementing the pension – changing the taper had no discernible impact). But, as discussed above, we are concerned about the assets test, not only in terms of savings behaviour impact but also in terms of 'justice' where extra mandated or voluntary savings may reduce a person's retirement income. We believe a merged means test could be designed to avoid these concerns and to simplify the rules, facilitating greater cohesion.

As mentioned, cohesion would be improved if all three pillars were regularly presented in terms of the indexed annuities they could generate. Mandating funds to offer CIPRs would also assist, ensuring retirees receive guidance about the products they should explore, reducing the need for detailed professional financial advice, and encouraging some rationalisation of funds involved in the pensions phase (and promoting more pooling). It is important, given the scale of funds involved, that

from about age 50 people are able to review their likely retirement incomes from pillars 2 and 3, and to use modelling tools to assess likely eligibility for pension. This would assist planning in the period ahead of retirement, including about whether additional pillar 3 savings would be appropriate and about the appropriate balance between superannuation and home savings.

More work is needed to achieve greater cohesion between the retirement income system and health and aged care. Critical to this is the treatment of home assets in the age pension and aged care means tests. The CSRI concluded that the value of the home should be included in the means test, but with a high threshold; a firmer requirement should apply that home assets be used to purchase accommodation in case of the need for residential aged care. Ideally, such moves should be accompanied by products that allow the release of home equity into income streams.

As the Paper mentions, research shows most Australians do not actively engage with their superannuation or in long-term retirement planning. Some funds have also reported that most of their members do not want to engage in any detailed way and much prefer to be guided in the decisions they must make. In our view, this suggests strongly the benefits of:

- Mandating minimum contributions (pending clear evidence that a lower SG would deliver adequate retirement incomes for those on incomes up to a little over the median, we continue to support an eventual increase to 12%);
- Rationalisation of default arrangements along the lines recommended by the Productivity Commission;
- Mandating funds to offer CIPRs suited to broad categories of retirees, aimed to include appropriate management of longevity risk.

Indeed, there is also a case for the Government to sell indexed annuities (at a price determined by the Government Actuary).

CONCLUSION

The key challenge for the Australian retirement income system is how to take full advantage of its primarily Defined Contribution basis (including inter-generational equity and financial sustainability) while also achieving an outcome broadly similar to that of Defined Benefit social security systems overseas (including adequacy, security and cohesion).

15 January 2020

Canberra

ATTACHMENT A

CSRI PAPERS

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