Submission to the Retirement Income Review

by Lorraine, January 2020

The interaction of the Pension System and the Superannuation System

My submission broadly addresses Consultation Questions 19, 22 and 26 regarding the effect of the current tax concessions on the sustainability of the system, and the problems arising from the integration of the Pension and Superannuation systems including the resulting disincentives for individuals and households to save money both inside and outside of Super.

I will illustrate how the total income of retirees varies with increasing assets and why this results in perverse outcomes which favour the very poor and the very rich at the expense of those in between. This in turn is a disincentive to households to save unless they are confident of being able to attain a very high level of assets and income.

I have included suggestions on how the system could be improved to increase its sustainability, reducing the cost to the Government, while at the same time eliminating the disincentives to save. These changes would make the system more equitable, particularly to those in the centre who do not qualify for a pension but who do not earn enough to benefit from tax concessions on their super.

Sustainability

With some forward planning any retiree over the age of 60 can organise their financial affairs so most or all of their assets are in pension mode super so they pay little or no tax almost regardless of how much income they have. The cap on pension mode super has mitigated this a little, but the tax rate on the earnings on this excess amount is still low. The income for a couple before any tax applies can be well over $200k.

With an increasing proportion of retirees to taxpayers this tax free way of life may not be sustainable in the long term. On the one hand we definitely want to encourage people to save for retirement and tax incentives are an important part of this. On the other hand we do not want a system where retirees can use superannuation as a tax shelter for very high incomes.

It would not seem unreasonable to ask a retiree couple with a combined income above $200k to pay at least a small amount of tax, when a working couple on the same income would pay over $50k.

Interaction of Pensions and Super

I have included in Chart 1 below a graph of income and assets for Australian retirees splitting their income into its components. This is for a couple who have a range of bank and share investments with an average return of 5% including the value of the franking

credit. These couples have the first $800k of their assets held outside of super to take advantage of the seniors' tax free threshold of around $60k and the rest in a SMSF.

I have covered combined asset amounts for the couple from zero to $5m. To keep this in perspective as you go from left to right of the chart you get fewer couples in each asset band. Around 2.5m people receive an aged pension of a total of around 3.5m over 65's, so around 70% of retirees would fall in the first 20% of the asset bands. There are around 200k SMSFs with assets over $1m and around 25k funds with assets over $4m.

Not all retirees hold assets in a SMSF, however those with institutionally managed super would have similar values on the chart although they would see their income as the pension stream they are paid rather than the earnings on their investments inside the fund. Some retirees have unfunded defined benefit pensions. There are also retirees who were unable to take advantage of super concessions or who chose not to and these retirees would be paying tax on their investment earnings at normal rates.

This chart would however be a typical, valid and more or less optimal strategy for many retirees, with enough cash available to pay their super pension amount when needed and their shares held in conservative blue chip companies eg CBA and TLS, listed investment companies eg ARG or WAM and REIT's such as SGP.

A larger format version of this chart is included on page 13.

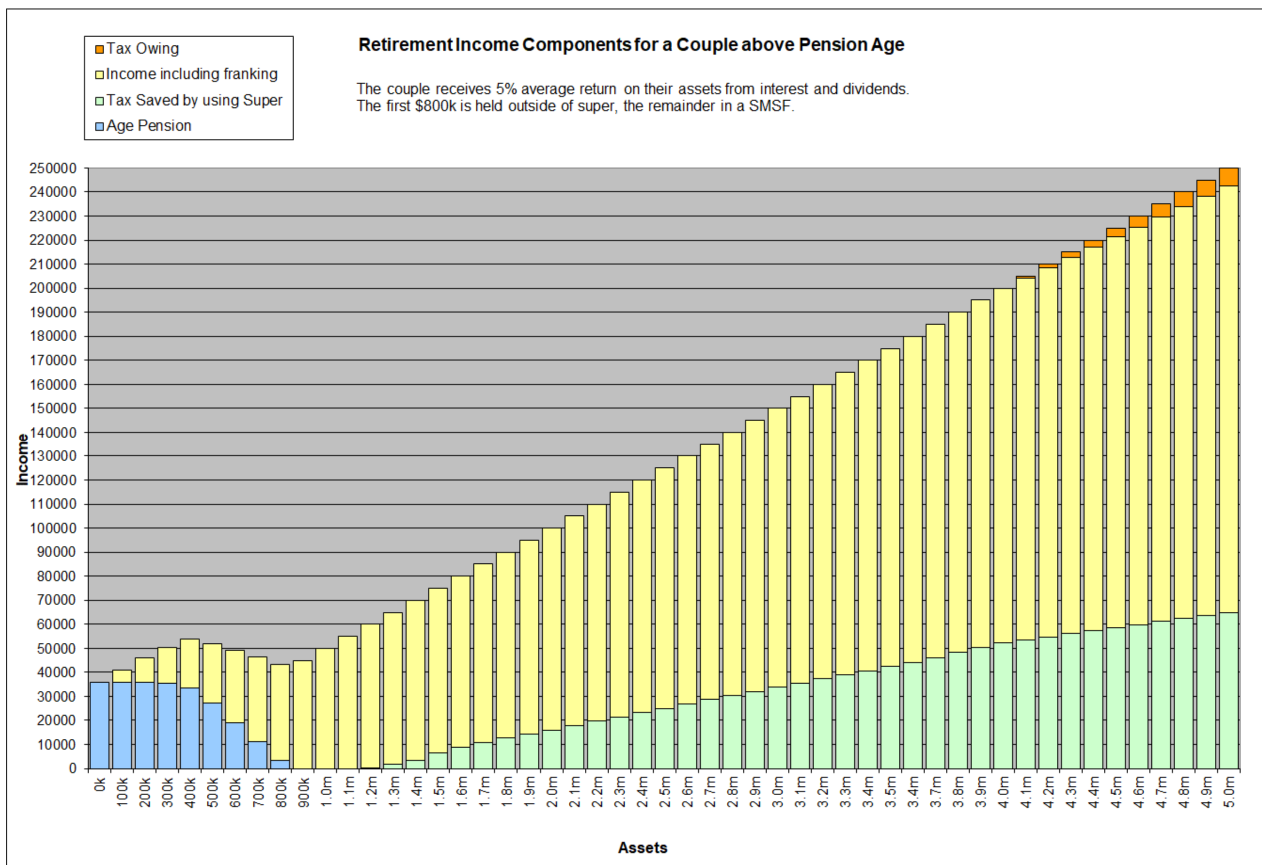


Chart 1 – Components of Retirement Income Cash & Shares

The blue area of the graph is the age pension, the green area the tax benefit gained by having the income inside super, the yellow area is the remainder of the income and the orange the tax payable. The available to spend income for each group is everything in their column except the orange.

The tax benefit is the tax that would be payable if all of the income was outside of super and includes the Medicare levy, the low income offset, the new low and middle income offset and the seniors offset.

For those retirees with a more timid attitude to investing who prefer the safety of term deposits to the risk of shares or managed investment funds the chart looks far more dire.

Chart 2 shows the same couples but this time they have invested their funds at 2%, which is higher than any term deposit currently available although a small number of bank accounts still return this.

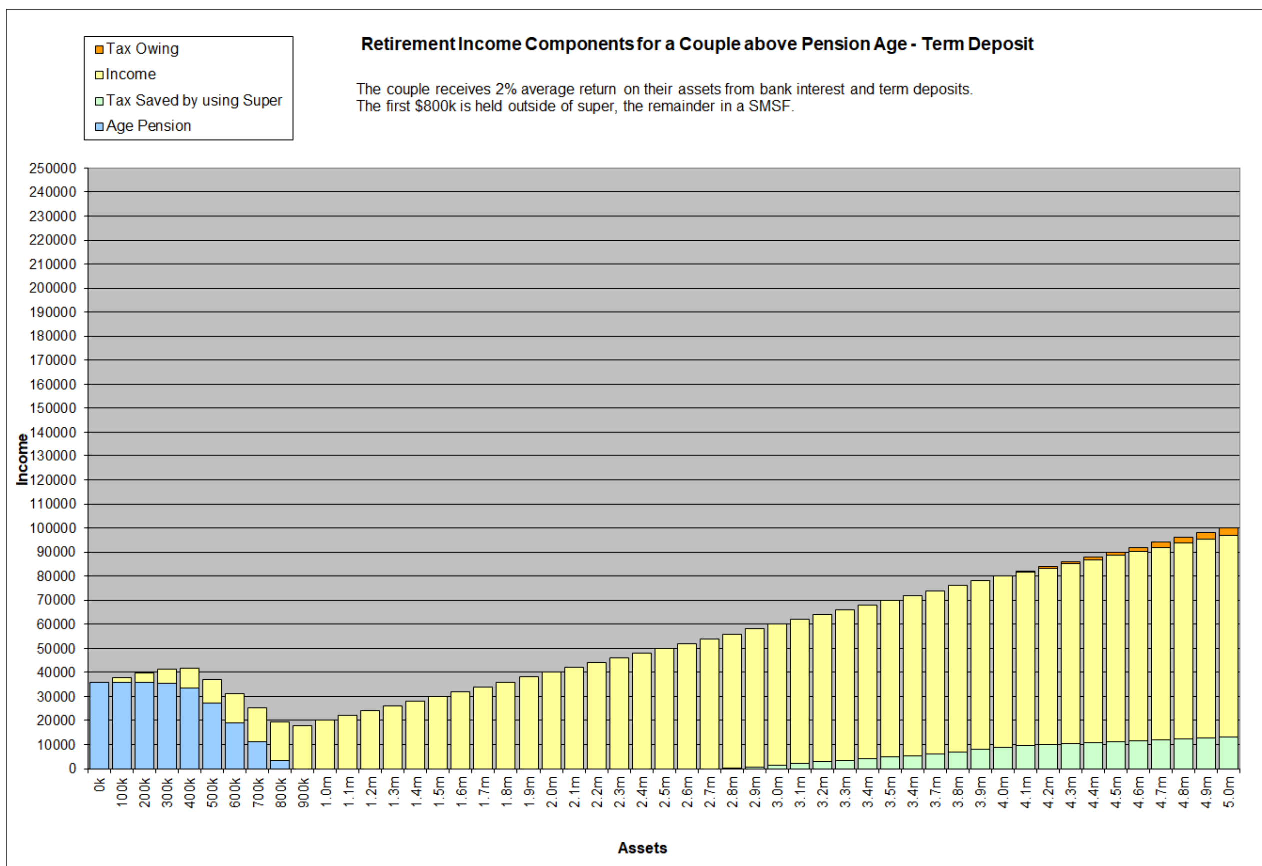


Chart 2 – Components of Retirement Income Cash Only

A larger format version of Chart 2 is included on page 14.

This is not a well thought out system

This is not the picture of a well thought out retirement income system. The age pension and tax benefits favour only the retirees with the lowest and highest assets. Those in the middle get no benefit at all.

When you take into consideration the interaction between the Pension, Super and Tax systems there are many perverse effects that form disincentives to save and incentives to increase risk. The whole system is so complex that it is near impossible for most people to work out the optimal strategy for their situation.

The low interest rate environment which the economy is currently experiencing is unlikely to improve any time soon. The effect on the income of retirees using term deposits and bank account investments has been profound and devastating. Around ten years ago term deposit rates were around 6%, now they are less than 1.5%. The income for a retiree couple with $1m to invest has reduced from $60k per year to $15k per year over that time.

The Pension system has not adequately adapted to the changing interest rate environment and the situation of these retirees worsened in 2017 with the increased taper rate for the pension assets test. These retirees were deprived of even more of the income they had expected and planned for when they retired when they lost the part pension they had previously qualified for.

Both the assets taper rate and the deeming rate need to be reviewed and I have offered suggestions for this further on. At the very least these figures should be set and regularly reviewed by an independent authority using current rates of return easily accessible to pensioner retirees. Those most affected by the deeming rate in particular are those with assets low enough to qualify for a pension and these people should not be putting their money into risky investments.

The Income Sump

There is a deep income sump for retirees with savings from $500k to $1.2m mainly caused by the very steep assets taper rate for the age pension. Those retiree couples who have managed to save $1m have a lower income than if they had only saved $400k.

There is little incentive for any couple to save an amount over $400k unless they are able to save $1.2m or above. For those retirees who prefer the safety of bank investments the savings target becomes $2m.

The current assets taper rate for the pension and to some extent the current deeming rate result in most retirees going backwards in income with increasing financial assets.

For couples in the asset taper range between $395k and $864k a reduction in assets of $100k gives an increase in pension of $7,800 a year. If their $100k is invested in a term deposit paying 1.5% then spending their $100k gives them a net gain in income of $6,300. This is a huge incentive to spend some of their capital on home renovations, holidays, lifestyle improvements or even simply storing cash under the mattress. It certainly does not encourage those approaching retirement to increase their savings at the expense of their current spending and lifestyle.

For those couples who retire with only a small amount above the assets test limit there is an incentive to spend enough to qualify for a small part pension as there are many other benefits associated with being a pensioner that they would thereby gain.

As most couples could not save enough to be outside the Pension system when they retire it is no wonder that many Australians do not engage with their Super. Many of them would see their Super as benefiting the Government by reducing the amount of pension they would receive rather than as a benefit to themselves in providing a higher income in retirement.

The system encourages risk

The current levels of the deeming rate results in many retirees experiencing effectively negative interest rates on their savings. The current rate offered by major banks on retiree savings accounts is 1.3%. This income is deemed to earn 3%, reducing their pension by half of this so their net return on savings is -0.2%. Again they would be better off spending the money or hoarding cash.

Yes, hoarding cash is illegal, but I question whether we should be putting elderly people whose capacity to think logically may be impaired in a position where this is their best option for maximising their income while retaining their capital.

The deeming rate issue is worse for pensioners who are in residential aged care. Their savings are assessed at the deeming rate of 3%, reducing their pension by half of this. Their means tested aged care fees are then calculated on the total income so the remaining half is deemed again and their total loss of interest is 2.25%. The return on their savings if their account pays 1.3% interest is -0.95%.

The unrealistic levels for the assets test taper and the deeming rate encourage retirees to take financial risks in investing their savings. In particular those retirees who have relied on bank term deposits for their income and have become increasingly desperate as interest rates have fallen will not have the skills to safely invest for a higher return.

This leaves them more vulnerable to questionable investment schemes as well as frauds and scams.

These retirees have no way of recovering from financial losses as they no longer work, so it is important that the system does not encourage them into taking more risk than is prudent.

The cap on pension mode super does not raise a lot of tax

The cap on the amount allowed to be held in pension mode super results in only a very small amount of tax owing for these couples, at least for the investment strategy and the asset range up to $5m that we are considering here.

Couples with incomes above $150k can afford to pay some tax on their investment earnings. Couples with incomes above $200k should be paying tax. The cap on pension mode super has not achieved this.

The orange area on Chart 1 shows what a pathetic amount of tax is actually being raised from only a small number of investors with multi-million dollars in assets and incomes well above the average for Australian households.

And this small increase in revenue has been achieved by a huge increase in complexity of the Superannuation system resulting from the introduction of the pension mode caps. This has made the system vastly more difficult to navigate for everyone, not just the few who are directly affected by the measures.

For some retirees the tax benefit is more than they would receive as a pension

For some retirees, the tax benefit of holding their assets in super exceeds the amount they would receive if they qualified for an age pension. This defies logic. We give retirees a tax benefit higher than the age pension to encourage them to save enough so we can avoid paying them the age pension. Unbelievable.

The tax benefit exceeds the pension amount for those couples with a joint income above about $150k. In my chart this is those retiree couples with joint assets above about $3m. These retirees save more in tax than they would receive if they qualified for a pension. They could easily afford to pay some tax on their income.

The tax on super above the $1.6m cap has not fixed this. Our couple with $4m saves nearly $46k in tax by having their assets in super, well above the couple pension amount of around $36k. Our couple with $5m saves a whopping $65k in tax.

So how can we fix this?

Although I appreciate that this is outside of the terms of reference for this review I am offering a few suggestions on how we could deal with these problems in a fair and equitable way, with no disadvantage to anyone except very high income earners and with only small changes.

Adjust the Deeming Rate

For starters we could adjust the deeming rate to something more realistic and set up an independent panel to review the rate twice a year with reference to prevailing bank account and term deposit interest rates.

To allow for the fact that some better off retirees do receive higher rates of return than the current deeming rate by using investment funds and shares, we could keep the current higher rate but apply it only from a much higher asset value.

A plausible scenario for deeming which would align more closely with real world investment returns would be as follows

From	To	Rate
$0	$50k	nil
$50k	$200k	1.0%
$200k	$500k	1.5%
$500k	and above	3.0%

Offer better investment products for seniors

There are few products available for retirees which combine a reasonable rate of return with safety of capital. Safety of capital is imperative for retirees who no longer work and have no way to replenish lost savings.

I would suggest a scheme where the Government issues Seniors' Bonds at a return of around 4%. The proceeds would be used for infrastructure projects, employment schemes, social housing or loans to local government bodies and the capital would be Government guaranteed.

The bonds could be purchased and redeemed online or through Post shops. They would have a face value of $100 and a small spread between the buy and sell price. Interest would be paid quarterly. Bonds bought and redeemed between interest payments would have the price adjusted to reflect accrued interest. They would be available only to those above retirement age and a cap of $300k could be placed per bondholder.

These bonds would be attractive to retirees who did not have the confidence to invest in financial markets and would carry no risk of capital loss. The funds raised would be useful for the Government and although the interest cost would be higher than issuing conventional government bonds, the total amount of bonds issued would not be high. The bonds would have an age restriction on the allowed investors and a cap on the amount per investor. This would form a natural limit on the number of bonds on issue.

The social benefits of this to both retirees and the community would be enormous compared to the cost of the scheme. Retirees would have a safe way to earn a reasonable return on their savings and the Government would have a pool of funds to use for community projects and to improve both physical and social infrastructure.

Return to the previous assets test taper rates

We could return to the previous assets test taper so retiree couples in the $850k to $1.2m asset brackets were not reduced to an income lower than they would have if they had saved less than half of this amount. This would eliminate the dip in the graph where retirees who have saved $1m have less income than if they had saved only $400k. We could pay for this by introducing a small tax on pension mode super.

Better still would be to reduce the taper rate to be equivalent to the higher deeming rate, currently 3%.

At the same time we could exempt household effects and vehicles from the assets test, or at least the first $10k for household effects and $20k per vehicle.

I find it quite bizarre that household and personal items are included in the assets test but the family home is exempt. Are pensioners expected to sit and sleep on the floor, eat from paper plates and become nudists? The minimum assessed value is usually $10k, for which pensioner retirees are losing $780 dollars a year of pension. In most cases these assets would be worth nothing at all if you attempted to sell them.

Reducing the taper rate is the ONLY way this income sump can be eliminated. Retirees would need an investment return of 7.8% to overcome the current loss of age pension income and this rate of return is difficult to achieve safely.

Eliminate the Assets test altogether

A better approach would be to eliminate the assets test altogether and use deeming for all assets, with the exception of low values of household and personal items, vehicles below a reasonable value and the family home.

This could be achieved by allowing a minimum of $30k in assets for a single pensioner and $50k for a couple before the deemed income was assessed on the assets.

All retirees would then be assessed solely on income, using deeming rates similar to those suggested above.

Eliminating the assets test would see investment properties, holiday homes, investment art works and boats assessed in the same way as financial assets. The assets taper rate would no longer be relevant.

Tax pension mode super

We could initially tax the earnings on all pension mode super at a rate of 5%, rising to 10% after a year or two and eventually to 15%. This would affect all super funds equally.

A 15% tax rate on all super fund earnings may result in some pension mode super being converted back to accumulation mode so there was no minimum withdrawal required. However this could be fixed quite easily by requiring everyone over the age of 70 to take out a minimum of 5% per year of their total balance.

It would in fact eliminate the difference between accumulation and pension mode super entirely and this would vastly simplify the super system, particularly for those retirees who have converted to pension mode but still do some part time work so they have an accumulation account as well as their pension account.

If the tax on pension mode super resulted in retirees paying tax when they would not owe tax if the money was held outside of super, then they could simply close down their super fund and invest their money in their own names.

Alternatively some of the tax on the earnings within the super could be refunded for those on low taxable incomes as is presently done for the contributions tax for low income earners.

I have included as Chart 3 below how this and halving the age pension taper rate would change the graph to look much more reasonable. A larger format version of this chart is on page 15.

Although still not ideal, this is more what a well planned retirement income system should look like and the changes are not major.

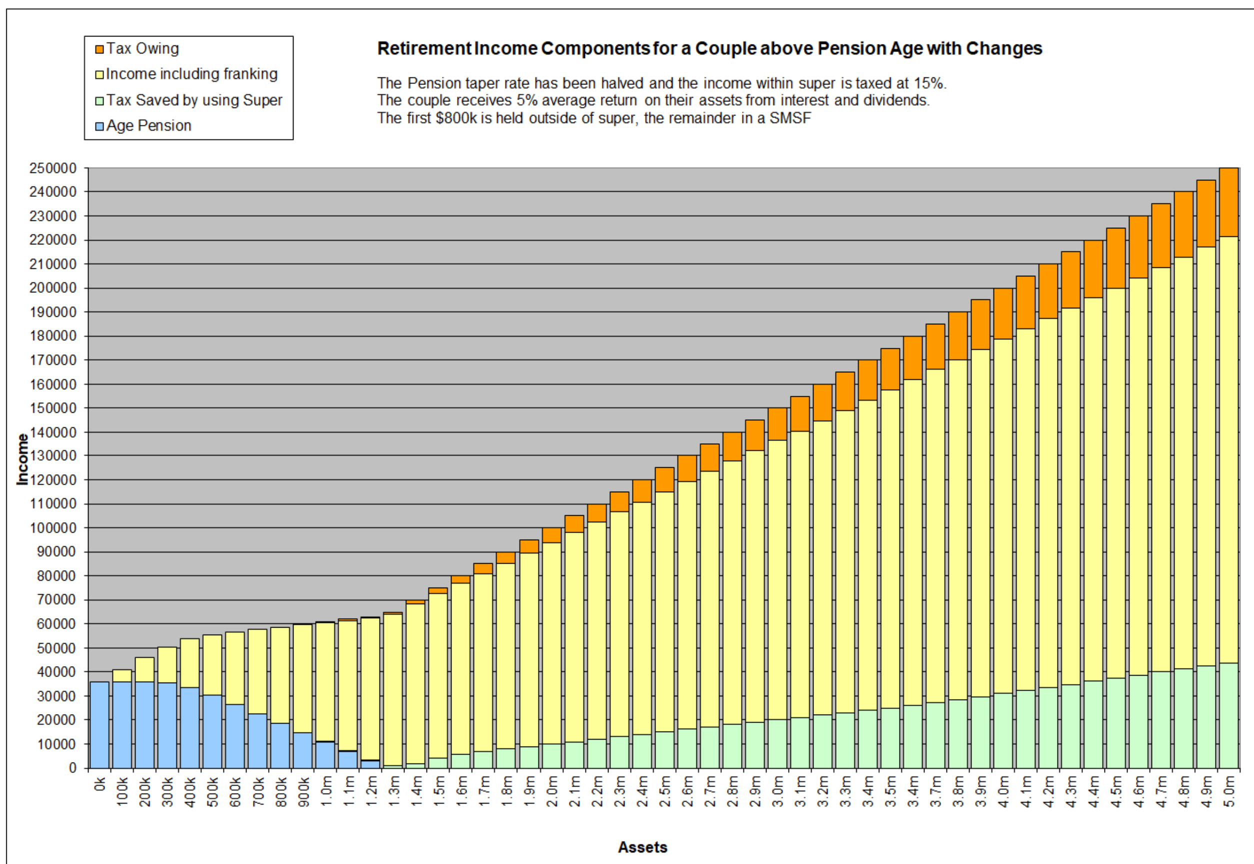


Chart 3 – Components of Retirement Income with lower assets taper and super taxed at 15%

The income sump has been flattened by the change to the asset taper, and every retiree gets some benefit from saving more.

No retiree in the range considered has a tax benefit higher than the age pension.

The highest marginal tax rate that any retiree pays is 15%. I have assumed all couples split their assets between super and non-super to take advantage of the $60k tax free area for personal tax and have the remainder of their income in super so they pay the minimum total tax.

A small increase could be made in the SAPTO so the income was tax free up to around $80k for a couple.

With this scenario the government gets some new tax revenue from higher income earners with no effect on those couples earning less than $80k. This should cover the extra pension paid by reducing the asset test taper rate.

Pay all retirees a pension and tax all income

A longer term solution would be to pay everyone over 67 a basic non-means-tested and tax free amount and make all other income taxable at normal rates.

This basic amount would not need to be equivalent to the current pension. Low income earners would receive an additional payment to increase their income to the current pension amount. This would be assessed on income alone, including deemed income on all assets except the family home and contents and vehicles. Alternatively it could be assessed wholly on taxable income.

Anyone not qualifying for the additional pension amount would receive the basic amount either paid fortnightly or as a refundable tax offset.

Retirees would pay tax on the earnings on their super as well as on their non-super investment income. Note that the earnings on the assets in the super fund would be taxed, not the amount paid by the fund to the retiree as an account based pension. This would remain tax free.

A level of $12k per person would seem reasonable, being about half the single pension amount and this would be indexed in the same way as the pension.

This would be paid for by eliminating some existing tax offsets and by replacing the current tax benefits of pension mode super with the basic payment.

Everyone over pension age who does not qualify for a full or part pension above the basic rate would receive the same benefit.

New low income retirees would apply for the income tested pension supplement to bring their amount up to the current age pension rate, so there would be no effect on full pensioners. Part pensioners currently being paid more than the basic amount would also retain their current level of pension. Part pensioners below the level of the basic amount would have their pension increased to the basic amount.

The basic payment would not form part of a retiree's taxable income, although the supplement to bring the amount up to the current pension rate could be included.

All other income would be taxed at normal rates and the SAPTO and possibly also the low income rebates would be replaced by the basic payment.

Retirees could still leave their super in their fund. Tax free pension mode super would revert to accumulation mode and the fund would pay tax on the earnings at the usual 15%. The fund would send a statement at the end of year to the retiree stating the taxable earnings on their balance including any realised capital gains and the tax already paid. The retiree would include these amounts in their tax return and tax would be levied at usual rates on their normal income plus the earnings on their super.

Those retirees who opted to take their basic payment as fortnightly payments would then pay the resultant net amount of tax, those who chose to take their payment as tax offset would receive it as part of their tax refund.

No pensioner would be worse off and a retiree couple could have around $130k in income before they paid any net tax.

Incentives to spend money to increase the pension would all but disappear, and the value of the family home would no longer be relevant, so retirees could downsize without needing to consider the effect of increased assets on their pension.

Accumulation super would be retained in its current form, with the usual caps on contributions, to encourage people to save for a better standard of living in retirement. There is, of course, nothing stopping people saving as much as they can afford to outside of the super system.

While this may have an effect on the financial planning industry as convoluted planning to maximise age pension income and minimise tax would no longer be needed, at least the accountants involved could get on with doing something more productive with their time. And no-one could argue that this system was not fair and equitable.

This system is illustrated in Chart 4 below and it looks far better than the current system. Low income retirees still receive the same pension as before, higher income retirees pay some tax but not as much as they did while working, no-one receives a benefit that is higher than the pension, and everyone who saves for their retirement gets some benefit from their savings.

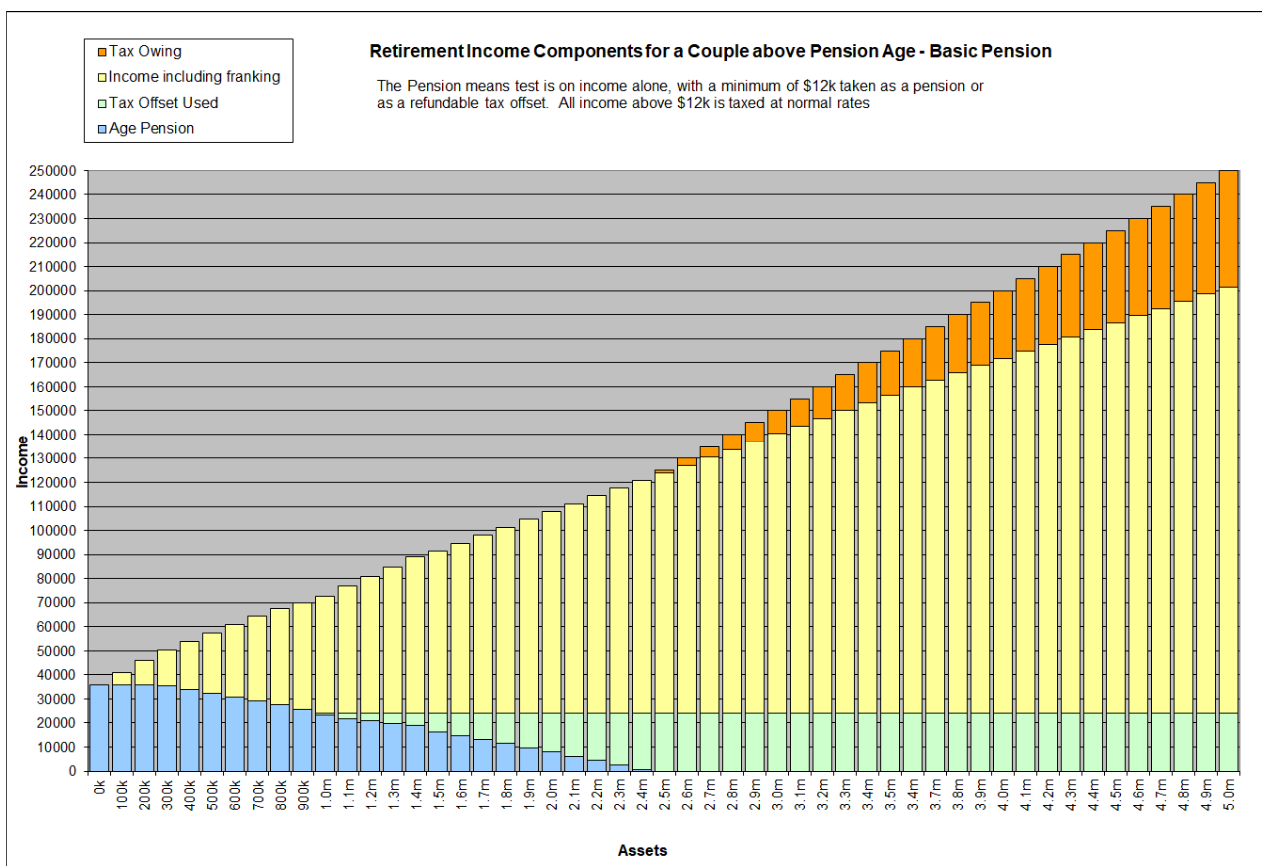


Chart 4 – Components of Retirement Income for Basic Universal Pension of $12k

A larger format version of Chart 4 is included on page 16.

This could easily be revenue neutral for the Government as the tax now paid by high income earners would cover the increased benefit to those in the centre who currently get no government support at all beyond a small amount of SAPTO.

Conclusions

I have highlighted problems that result from the interaction of the Pension and Super systems as they currently stand and suggested solutions that would improve the current system and would be quite simple to implement.

Changes are needed to remove the disincentives to save, help retirees to invest safely and reduce the use of super as a tax haven.

Any changes, once proposed, need to be open to public comment as there are always unforeseen and unexpected effects that need to be addressed. Changes need to be legislated at least a year before they are implemented to give retirees the opportunity to adapt and some changes may need to be grandfathered.

If the review panel would like to discuss any aspect of this submission, or would like further charts showing different scenarios then please feel free to contact me.

Lorraine

January 2020

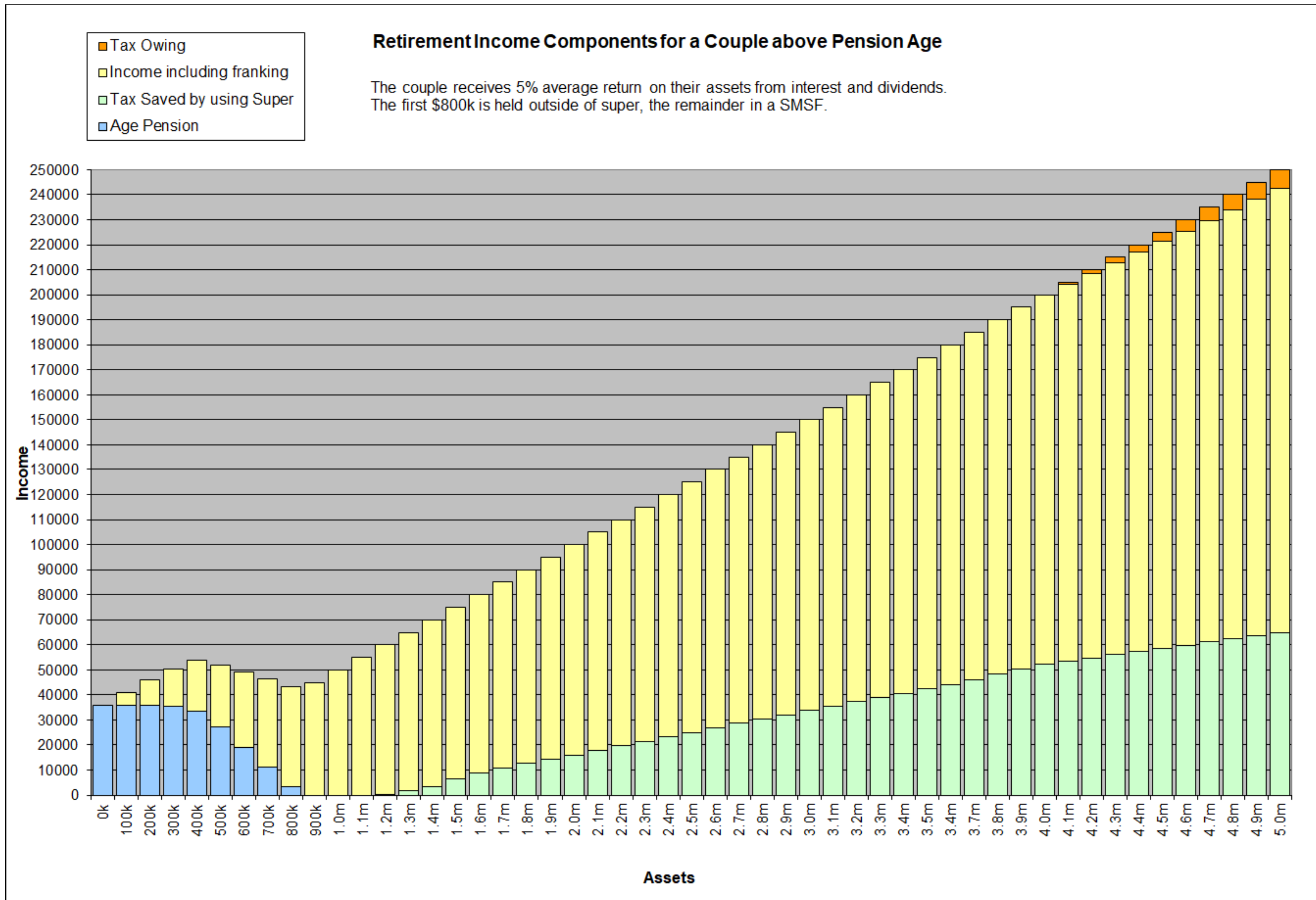


Chart 1 – Components of Retirement Income

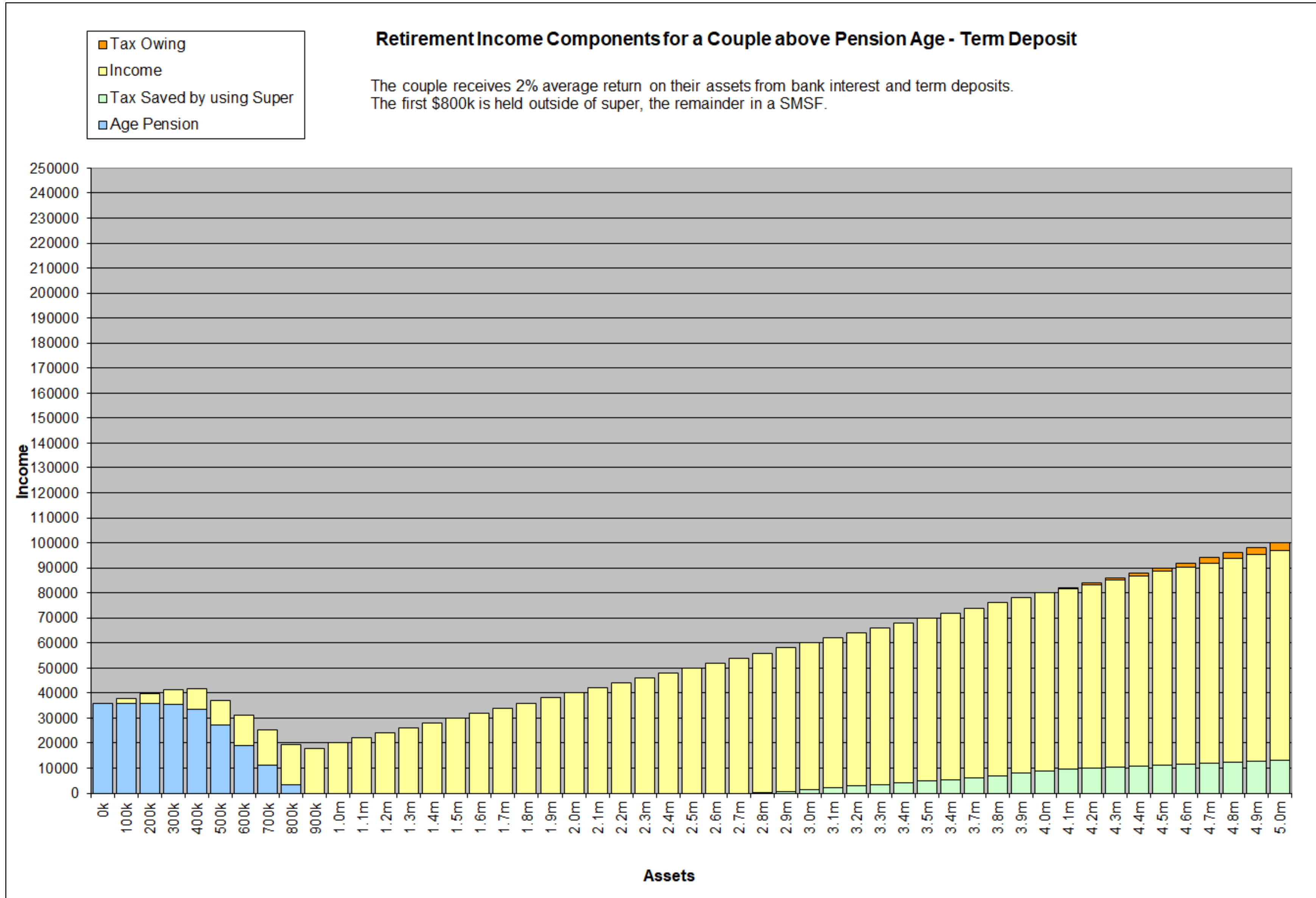
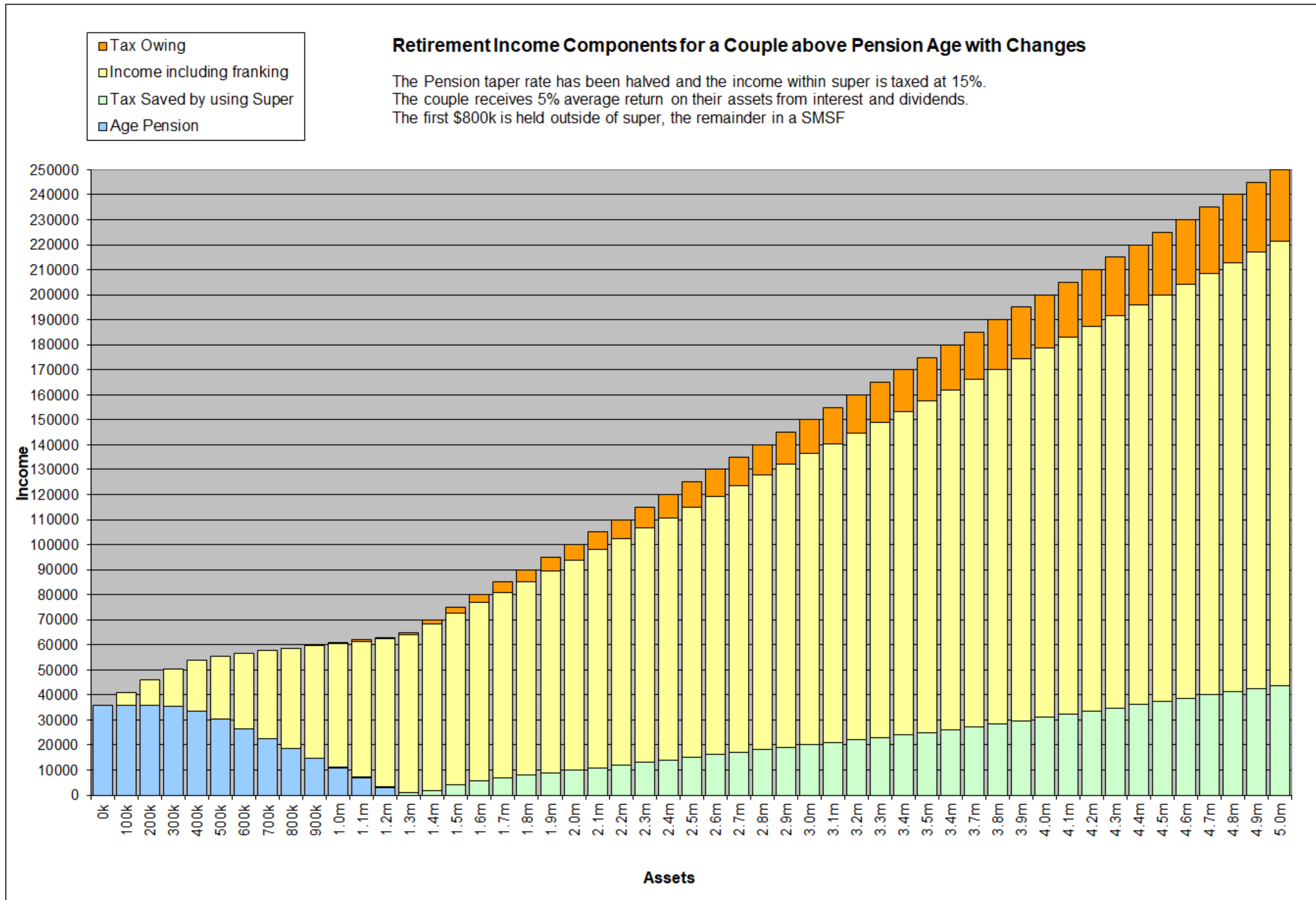


Chart 2 – Components of Retirement Income Cash Only



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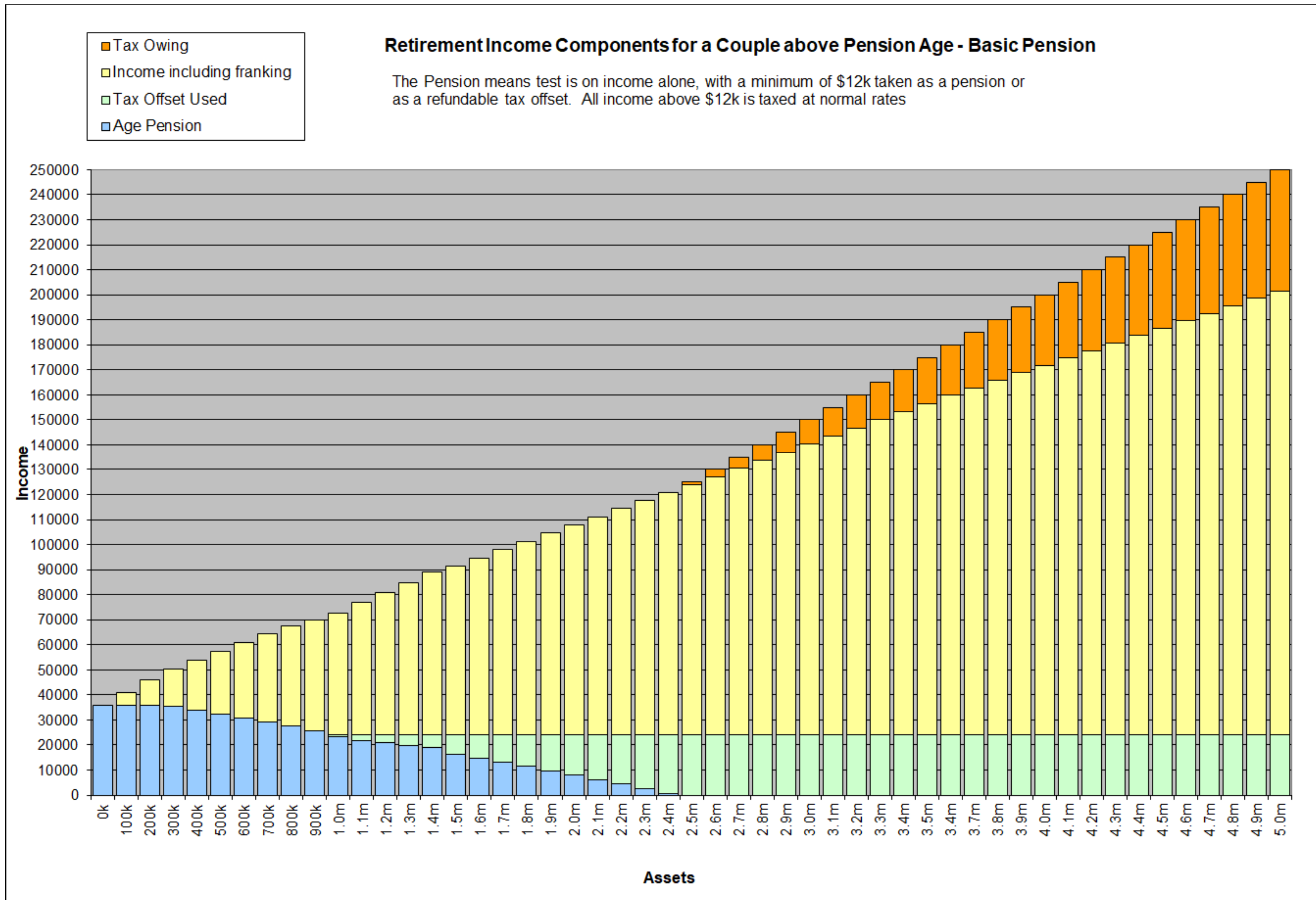

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