HEALTH WEALTH CAREER

SUBMISSION TO THE RETIREMENT INCOME REVIEW

3 FEBRUARY 2020

MERCER

CONTENTS

EXECUTIVE SUMMARY

Mercer recognises that the Panel has been tasked with establishing a fact base to improve the understanding of the Australian retirement income system and, in particular, how it is operating. We have therefore concentrated on providing evidence and, as a result, make several observations which are highlighted throughout this submission.

We also highlight several topics below which we believe would be helpful for the Review to explore to improve the overall system.

Importantly we would stress that the Australian retirement income system is not broken; in fact, as noted in the Consultation Paper, the 2019 Melbourne Mercer Global Pension Index (MMGPI) ranked the Australian system third out of 37 retirement income systems. Notwithstanding this good ranking, there are several areas where improvements can be made.

RECOMMENDATIONS

It is recommended that the Retirement Income Review consider and explore how to implement the following changes to improve Australia's retirement income system and so provide better outcomes for future Australian retirees:

- There is an urgent need to determine the objectives of the overall system as well as the objectives of each pillar. Agreed objectives would clearly assist in the development of long term public policies.
- There must be a stronger focus on the provision of retirement income, as distinct from accumulation. A requirement to provide income projections to members should represent an important step in this development.
- Under the current arrangements, the SG should rise to 12 per cent, as currently legislated, to provide an adequate income.
- Mandatory superannuation should be expanded to cover all those in the workforce, thereby improving adequacy and equity.
- There must be clearer and simpler integration or improved cohesion between the pillars
- The current means tests for the Age Pension need to be simplified and made more consistent.
- There is a need to establish a suitable legislative and regulatory framework that provide simple, affordable and trusted advice to be provided to all retirees, including the use of intra-fund advice from superannuation funds.

We also recommend that the Panel consider alternative structures, such as the introduction of a universal Age Pension (with a focus on those with less superannuation), which would lead to a much simpler system for retirees and could be afforded with some adjustments to superannuation taxation and the SG rate.

We recognise that any changes to the Age Pension or superannuation arrangements may require appropriate arrangements over time to ensure a smooth transition for individuals and the superannuation industry.

Insurance in superannuation is an important subject within the system but this topic has not been covered within this submission, given the Review's focus on retirement income. However, we suggest the role and purpose of insurance within superannuation should be reviewed at a later date.

Naturally, we would be delighted to discuss our submission with members of the Panel or Secretariat. If that is desired, please do not hesitate to contact me by phone (0404 800 869) or email (david.knox@mercer.com).

Dr David Knox
Senior Partner

Who is Mercer?

Mercer is one of the world's leading firms for superannuation, investments, health and human resources consulting and products. Across the Pacific, leading organisations look to Mercer for global insights, thought leadership and product innovation to help transform and grow their businesses. Supported by our global team of 22,000, we help our clients challenge conventional thinking to create solutions that drive business results and make a difference in the lives of millions of people every day.

Mercer Australia provides customised administration, technology and total benefits outsourcing solutions to a large number of employer clients and superannuation funds (including industry funds, master trusts and employer sponsored superannuation funds). We have over $150 billion in funds under administration locally and provide services to over 2.4 million superannuation members and 15,000 private clients. Our own master trust in Australia, the Mercer Super Trust, has around 230 participating employers, 239,000 members and more than $22 billion in assets under management.

1

SOME OBSERVATIONS ON THE CONSULTATION PAPER

The following comments apply to the Consultation Paper entitled *Retirement Income Review* and issued by the Australian Government in November 2019. These notes recognise that the published paper was kept relatively short and therefore did not cover every angle or nuance. Nevertheless, we hope the following comments will be helpful to both the Panel and Secretariat as they conduct the Retirement Income Review.

Page 4, Figure 1, The three pillars

Pillar 1 – The Government funded Age Pension

- Of course, due to means testing, the Age Pension is not received by all aged persons. However, the importance of the Age Pension for individuals increases with age, both in the amount received and the proportion of the aged population who receive it.

Pillar 3 – Voluntary savings

- The Pillar 3 box implies that voluntary savings are only made by individuals whereas the Pillar 2 box suggests that the Superannuation Guarantee (Compulsory superannuation) is made by employers. In fact, many employers make contributions in excess of the current SG rate of 9.5%. These include the Commonwealth public service (15.4%), universities (17%) and a range of private sector employers due to enterprise bargaining agreements or those who make additional voluntary contributions to cover insurance costs, administration fees or for female staff. Hence, employer contributions are not limited to the SG.

Page 5, Compulsory superannuation

There is no mention of the exclusions, including those earning less than $450 per month and the self-employed.

The second paragraph implies that “Tax concessions are provided for Compulsory superannuation” whereas these concessions apply to all employer contributions (including but not limited to salary sacrifice), as well as personal deductible contributions, up to the maximum cap for concessional contributions.

This paragraph also suggests that “earnings and income from superannuation are generally tax-exempt if aged 60 years or older.” This is only true if the individual has met a condition of release, such as retirement. Otherwise, tax-exempt investment earnings from pensions are only available after age 65, subject to the Transfer Balance Cap of $1.6 million.

Page 6, Figure 3, Key retirement income system interactions

This is a helpful diagram and highlights the complexity of the current system, although the following additions would be useful:

- The tax advantage for housing is noted. However, the main residence is also excluded from the assets and income tests for the Age Pension and other benefits.

- The earnings on superannuation assets in pension phase are tax exempt, subject to the Transfer Balance Cap of $1.6 million. Hence these investment earnings are not taxable. These could be considered separate from the "Tax advantage for superannuation savings".
- One of the important roles of the Age Pension is to protect retirees from market and longevity risks. That is, if the value of their superannuation and other financial assets decline in value, many retirees will receive an increased Aged Pension. Similarly, the Aged Pension provides Government-backed longevity protection which is very valuable.

Page 7, How Australia's system compares internationally

According to the second paragraph, "Australia's 'second pillar', a privately-managed …. defined contribution scheme requires the individual, rather than the Government or employers, to bear the risks associated with investment, such as longevity risk and inflation. However, as income drawn from this pillar is backed by assets in retirement*, it avoids risks of future governments reducing entitlements to address budgetary pressures that can occur in unfunded or partly funded social insurance schemes*."

We question whether the italicised comment is strictly accurate given the stronger assets test which applied from January 2017 and the taxes applied to superannuation funds and benefits which can have a significant impact on the net income received by the retiree. Other recent examples also include objections to the imposition of the Transfer Balance Cap and Labor's policy proposal to end refunds of excess dividend imputation credits.

Page 12, Principles for the system

We note that the Consultation Paper proposes four principles to assess the performance of Australia's retirement income system. Whilst we support these four principles, we believe there are another two that have been omitted; namely efficiency and simplicity.

There are many stakeholders operating within the Australian system ranging from the Government (including the ATO, APRA, ASIC, AFCA and DSS) through to superannuation funds, investment managers, insurers, administrators, consultants, financial advisers and individuals. The system is very complicated with rules constantly changing. As a result, it is costly to administer and most individuals do not understand it. Even applying for the Age Pension is complex and aged individuals are now paying consultants to help them complete the required form[1].

Whilst the Productivity Commission, in its recent work, considered the efficiency of the superannuation system, it is important for this Review to consider the efficiency of the whole retirement income system and how this could be improved – for example:

- better integration between the pillars would provide clearer incentives for Australians to save for retirement, and
- the removal of some of the complexities within each pillar.

The retirement income system, as a whole, primarily exists to provide financial support to retirees. That is, it provides benefits to individuals and households in the later years of their life, often when their cognitive abilities are also declining. The Australian system for retirees is very complex. Of course, other features of the system, such as taxation, could be simplified but it is the interaction with, and impact on, retirees that creates most uncertainty, concern, costs and

[1] One example is SuperEd who charge $165 for each age pension application.

some disincentives for positive behaviour. Simplification (or ease of understanding) should therefore be an important principle.

Page 18, Figure 4, Lifetime government support provided through the retirement income system

We agree that the three forms of government support for retirement are the Age Pension, tax concessions on superannuation contributions and tax concessions on superannuation investment earnings. However, the use of the discount rate of around 5 per cent per annum[2] as used to provide a net present value in 2018-19 dollars requires a comment.

Although this rate represents a reasonable estimate of the average increase of nominal GDP in recent years and hence the likely growth in future tax receipts[3], it is not a measure that reflects inflation, wage growth or even the government's borrowing rate. All these rates are much lower and better understood by the community and are often used to calculate net present values. The use of a lower discount rate would increase the relative value of future age pension payments due to the fact that they are assumed to be paid in 40-65 years' time and so change the shape of the graph. It is also worth noting that the graph is in respect of individuals and therefore could be considered from a per capita perspective. Hence the nominal GDP increase may not be appropriate. In short, it must be recognised that the selection of the discount rate, in particular, is critical as it inevitably influences the outcome.

[2] We also note that the discount rate of 5% pa was used in the 2016 Budget papers when the 10-year bond rate was at least 1% higher than the current levels.

[3] We note that this rate is used to estimate the present value of the unfunded pension liabilities relating to public servants' superannuation. However, this is now a capped liability unlike the value of Government support for retirement which applies to each individual and will continue to increase with population growth.

2

OBJECTIVES OF A RETIREMENT INCOME SYSTEM

Question 2 in the Consultation Paper asks whether the objective of the Australian retirement income system is well understood within the community. This presupposes that there is a clear objective. In fact, few countries have a clear objective for their retirement income system.

A. AN INTERNATIONAL COMPARISON

In the spirit of Question 1 in the Consultation Paper, Mercer asked our colleagues around the world about any stated objectives for their private pension system or the broader retirement income system. We concentrated on some of the top 12 countries in the 2019 *Melbourne Mercer Global Pension Index* (MMGPI) (namely Chile, Denmark, Netherlands, Singapore, Sweden, Switzerland) and those countries with similar social and cultural backgrounds with whom we often compare ourselves (namely Canada, New Zealand, United Kingdom and the USA). The results are shown below.

Canada (9th in the 2019 MMGPI)

The Old Age Security Program provides a universal basic pension together with supplements aimed at poverty reduction.

The objectives of the earnings-related Canada/Quebec Pension Plan are to provide "reasonable minimum levels of income available at normal retirement ages, to people who become disabled, and to the dependants of people who die". A 2017 report noted that the CPP provides a secure and portable earnings-related pension program that guarantees the lifetime continuation in retirement of a specific and defined portion of a contributor's average income (as well as clearly specified survivor benefits in the case of the death of a contributor).

Chile (10th in the 2019 MMGPI)

There are no specific system objectives. There are only pension objectives for the solidarity pillar, as follows:

a) Basic Solidarity Pension for people who did not contribute to system
b) Guaranteed Minimum Pension / Solidarity Pension Contribution for those who contributed for a short time and have limited savings.

Denmark (2nd in the 2019 MMGPI)

There are no particular objectives as such but there are some general thoughts behind the current system.

The Danish retirement system is based on an intention of providing a minimum income for those in need. The original definitions (minimum income, need etc.) are not very detailed, and can be dated back to the first Danish legislation on the public pension in 1891. Several changes and new laws have altered the basic rules of the public pension. ATP was added as a supplementary benefit saved by the individual employee, in addition to the savings through general taxes.

Netherlands (1st in the 2019 MMGPI)

There are no published objectives but the first pillar is to prevent poverty amongst the aged whilst the second pillar is to provide replacement income so living standards can be maintained during retirement.

New Zealand (8th in the 2019 MMGPI)

The purpose of KiwiSaver is to encourage a long-term savings habit and asset accumulation by individuals who are not in a position to enjoy standards of living in retirement similar to those in pre-retirement. The Act aims to increase individuals' well-being and financial independence, particularly in retirement, and to provide retirement benefits. These benefits are in addition to the universal pension.

Singapore (7th in the 2019 MMGPI)

The main stated objective is to ensure that the Central Provident Fund (CPF) can provide for basic retirement needs. In the event the CPF falls short of this objective (i.e. for the poor), top up payments and subsidies are provided by the government.

The main objective of the CPF is to be a comprehensive social security system that enables working Singapore Citizens and Permanent Residents to set aside funds for retirement. It also addresses healthcare, home ownership, family protection and asset enhancement. CPF savings will provide a monthly income for basic living expenses in old age.

Sweden (5th in the 2019 MMGPI)

There is no objective for the whole system.

Switzerland (12th in the 2019 MMGPI)

The pensions of the Federal Old-age, Survivors and Invalidity Insurance (i.e. 1st pillar) must be sufficient to cover basic living expenses adequately.

Article 113 of the Federal Constitution states the occupational pension scheme (2nd pillar), together with the Old-age, Survivors' and Invalidity Insurance, enables the insured person to maintain his or her previous lifestyle in an appropriate manner.

In article 111 it is stated: "The Confederation shall take measures to ensure adequate financial provision for the elderly, surviving spouses and children, and persons with disabilities. These shall be based on three pillars, namely the Federal Old-age, Survivors' and Invalidity Insurance (1st pillar), the occupational pension scheme (2nd pillar) and private pension schemes (3rd pillar)."

United Kingdom (14th in the 2019 MMGPI)

In a House of Commons Briefing Paper in February 2019, the following comments made in 2013 were referenced:

> "The Coalition Government estimated that - based on a cautious set of assumptions about changes in future saving behaviour - its reforms (auto-enrolment, the introduction of the new state pension in April 2016 and the bringing forward of increases in the State Pension age) will:
>
> - Reduce the number of people facing inadequate retirement incomes by 1 million;
> - Increase the incomes (and replacement rates) of 73% of those facing inadequate retirement income, bringing them closer to their target income; and

- Halve the proportion of future pensioners who will retire with no private income at all from 27% to 12% in 2050."[4]

With the Government's reforms in place, over half of the people currently of working age considered in the Government's analysis are expected to build adequate retirement incomes and maintain their living standards during their retirement. However, this leaves an estimated 12.2 million people facing inadequate retirement incomes. Roughly half of these are within 20% of their target amount, with the remainder facing a more significant challenge. This is a particular issue for moderate and higher earners.

United States of America (16th in the 2019 MMGPI)

Although the objectives of the US retirement income system have not been defined, the goals of Social Security have been relatively consistent for many decades. To quote from an address in 1945: The recommendations to strengthen Social Security

> "have only one goal--to keep American families from becoming destitute--in health or in the essentials of life. We do not want a program which, alone, would enable anybody to live in luxury; but we do want a program that will assure every family in the Nation enough to live on in times of adversity."[5]

Summary

It is apparent that many, if not most, retirement income systems do not have clearly stated objectives or goals for the overall system. However, to the extent objectives or goals exist, it is evident there are two distinct but complementary goals:

1. The provision of a basic or minimum level of income through pillar 1 to alleviate or remove poverty amongst the aged.
2. The provision of retirement income that goes beyond this basic level. This is often expressed as the maintenance of living standards during retirement either at a modest level (for example, Canada and Singapore) or at a level that is consistent with the individual's previous standard of living (for example, Switzerland). However, it is worth noting that even in Canada and Switzerland there is the use of subjective terms such as "reasonable" and "appropriate" which go beyond poverty alleviation but are open to interpretation.

None of these systems have an objective for pillar 2 only (i.e. the SG in Australia). It is very difficult to have an objective for pillar 2 without an agreed objective for pillar 1 or the overall system.

In that respect, it is noteworthy that the Financial System Inquiry recommended that there should be clear objectives for the superannuation system and a public report on how policy proposals are consistent with these objectives.[6] The Report then suggested that the primary objective of superannuation should be:

> "To provide income in retirement to substitute or supplement the Age Pension".

However, such an objective cannot work in isolation. It implicitly assumes that there is an objective for the Age Pension and for the whole retirement income system. These do not currently exist. The

---

[4] Thurley, Djuna (2019), *Pensions: automatic enrolment – current issues*, Briefing Paper, February, p4.

[5] Altmeyer, Arthur J (1945), Goals for Social Security, A radio address, February 11.

[6] Financial System Inquiry (2014), *Final Report*, Recommendation 9, p95.

next section explores how broad objectives could be established which have implications for both the Age Pension and superannuation, including both the compulsory and voluntary components.

This international review suggests there are two relevant objectives for the Australian retirement income system:

1. The alleviation of poverty amongst aged Australians which is currently achieved through the provision of the means-tested age pension as well as support from the health and aged care systems.
2. The provision of retirement income to retired Australians to enable them to maintain a lifestyle that is broadly commensurate with their previous living standards. A related question is whether this level of income should be provided from both age pension and superannuation or whether, for example, the superannuation system should be sufficient for those with say, 30 or 40 years of full-time employment. The appropriate level of income and related issues will be discussed in the next section.

It is obvious there are at least two separate policy targets. The Tinbergen Rule, named after one of the first two Nobel laureates in economics, is a basic principle of effective policy. Distinguishing between policy targets, on the one hand, and policy instruments, on the other hand, Tinbergen (1952) argued that to successfully achieve n independent policy targets at least the same number of independent policy instruments are required. This has become known as the Tinbergen Rule.

In terms of retirement income, the two policy targets require at least two policy instruments, namely the age pension and compulsory superannuation, as a minimum. That is not a subject for debate and has been accepted by most commentators. The real debate relates to the interaction between these two instruments.

Observation

The overall retirement income system has two different but complementary purposes. The first is to ensure that no aged Australian lives in poverty. The second is to enable most retired Australians to maintain a lifestyle that is broadly commensurate with their previous living standards.

B. OUTCOMES FROM AUSTRALIA'S SYSTEM

As discussed in the previous section, there are two distinct purposes within the Australian retirement income system: poverty alleviation and income replacement. These objectives are primarily achieved for most older Australians through the Age Pension and superannuation (including both the compulsory and voluntary components). This section will discuss the current outcomes from these two sources and outline the foundation for an improved result.

The Age Pension

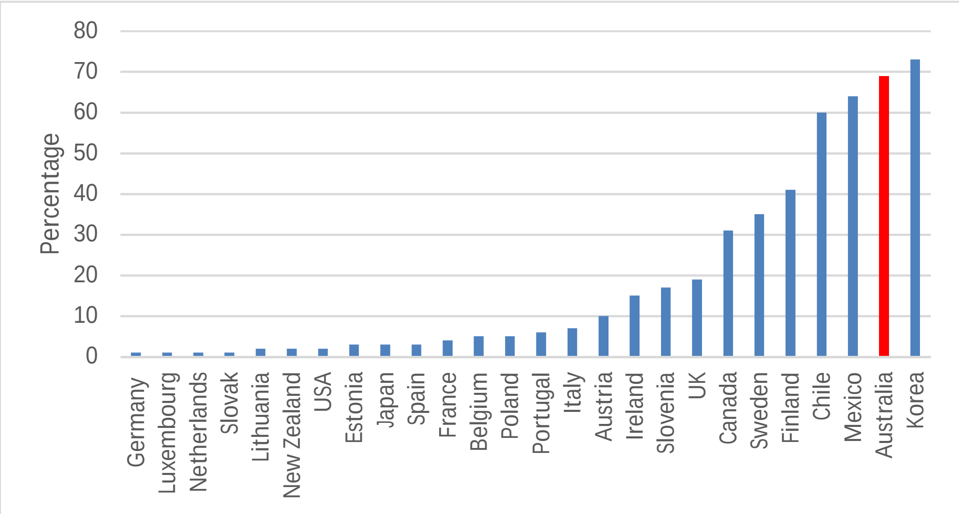
The means-tested Australian Age Pension is designed to ensure that no Australian above the pension eligibility age lives in poverty. Its current level of 27.8 per cent of the average wage for a single person is relatively generous on the international stage.

Although it is below the level of the universal pensions provided in New Zealand (39.9%) and the Netherlands (29.0%) and the minimum pension in Canada of 30.1%, it is above the targeted pensions available in Finland (17.2%), France (25.4%), Germany (20.0%), Ireland (25.8%), Switzerland (21.2%), UK (21.6%) and the USA (16.4%)[7].

Hence we do not believe there is an urgent need to revise the level of the full Age Pension, when expressed as a percentage of the average wage. Of course, a related issue is the minimum living standard that is appropriate for older Australians.

However, it must be noted that the Age Pension does more than alleviate poverty. Figure 2.1 shows the percentage of those age 65 and over in most OECD countries who receive a targeted (or means-tested) pension[8].

Figure 2.1: The percentage of those aged 65 and over who received a targeted pension in 2016



Source: OECD, Pensions at a Glance 2019: OECD and G20 Indicators, Table 4.2

[7] These percentages, expressed as a percentage of the average wage, are taken from Table 4.2 of the OECD's P*ensions at a Glance 2019.*

[8] It is noted that some countries have a minimum pension under their contributory-based pension system which is not means-tested.

It is apparent that most older Australians receive a part or full Age Pension. Under the current Age Pension arrangements, this is likely to continue for many decades even as the percentage of those receiving the full pension reduces.[9] Hence, the Australian Age Pension is not just about poverty alleviation. It affects middle Australia. That is, there is a high percentage of older Australians who will receive a part or full Age Pension at some point during their retirement years which, in most cases, has a significant impact on the level of their retirement incomes. However, this fact also adds considerable complexity to the design of the overall system.

The relative importance of a means-tested pension within a retirement income system is determined by the following three factors:

- The level of the age pension. That is, the higher the means-tested benefit, the more retirees will receive a part pension.
- The taper rates used. That is, a stronger taper rate means that the pension will be received by fewer retirees.
- The thresholds (or disregarded assets or income) used. That is, a higher threshold means a higher percentage of retirees will receive a full pension with the consequential effect that a higher percentage of retirees will receive a part or full pension.

It is also noted that the indexation measure used can influence the level of the pension when expressed as a percentage of the average wage. For example, price indexation is likely to gradually reduce the level of pension when expressed in terms of wages.

Within the current Australian system, it is noted that:

- The level of Age Pension is unlikely to be reduced significantly in real terms. Although price indexation has been considered, it appears that both major political parties have accepted that the pension level should be linked to wages.
- Taper rates have been adjusted from time to time. The income test taper rate remains at 50 per cent even though many countries adopt a stronger taper rate. The assets test taper rate was doubled from January 2017 although, at the same time, the threshold was increased.
- The income test threshold is unlikely to be decreased as this would immediately reduce pension income for many retirees. On the other hand, it is likely that the thresholds will be increased again in the future, should other changes be introduced.

Observation

The overall impact of these features is that most Australian retirees will receive a part or full Age Pension in the future. Hence, the actual purpose of the Age Pension goes beyond poverty alleviation. It provides the foundation of retirement income for most Australians. As such, it also provides a level of longevity protection.

As one considers the ongoing importance of the Age Pension, it should also be recognised that it represents an increasing level of real income during the retirement years. A simple example will highlight this effect.

[9] Actuaries Institute (2019), Options for an Improved and Integrated System of Retirement, Graph 4, p17.

Let us assume that a retiree uses their superannuation to purchase a price-indexed annuity payable from the pension eligibility age. Let's also assume that the retiree is eligible to receive a part Age Pension at this time. As the retirement years continue the Age Pension will increase in real terms as:

- The level of the age pension is indexed to wages and not prices
- The relevant thresholds will also increase enabling the pensioner to receive an increased pension.

This impact of increasing real Age Pension income received during retirement means that contrasting results are shown from models using similar economic assumptions.

For example, the OECD calculates the net replacement rate for the average income earner of the current system (including the legislated increase of the SG to 12%) to be 41.0% for males and 37.3% for females.[10] On the other hand, the Grattan Institute calculated that the average worker (or median income earner) can expect a retirement income of 89% of their pre-retirement income[11]. The equivalent figure for the average income earner was 78% - that is, much higher than the OECD figure.

The major reason for this difference is the period of retirement income that is being considered. The OECD calculation considers the income received in the first year of retirement. For the average income earner, this calculation shows that no age pension is received in that first year. On the other hand, Grattan averages the real income received over the assumed 25 years of retirement. For example, Grattan's 2018 publication indicated that the replacement rate for a median income worker was 91% when averaged over the 25 years but only 58% in the first year of retirement. The cause of the difference is the increasing real income received from the Age Pension due to the combined effect of means-testing and the indexation to wages.

Given that the median income is lower than the average income, the first year result from Grattan is reasonably similar to the OECD figure when one weights the OECD male figures for net replacement rates of 75.5% and 41.0% for 0.5 or 1.0 times the average wage respectively.

These initially contrasting results confirm:

- The increasing importance of the wage-indexed Age Pension during the retirement years, when income is deflated according to prices
- That in the early years of retirement, many Australians are unlikely to maintain the living standards enjoyed during most of their working life due to a range of factors as discussed in Chapter 5.

This outcome naturally leads to a discussion on the objectives of the whole system and how these are best achieved. The first step is to consider the desirable level of net replacement rates.

---

[10] OECD (2019) *Pensions at a Glance,* Table 5.5

[11] Grattan Institute (2019), *Money in Retirement: More than enough,* April

C. NET REPLACEMENT RATES

In their influential report *Averting the Old Age Crisis*, the World Bank (1994) made several important suggestions relating to Target Wage Replacement Rates:

1. The government should not necessarily mandate the full pension that might be desirable for individual households. That is, there should be some flexibility to enable some households to save more than the mandated level, if that is their desire.
2. Lower income earners are likely to need a higher replacement rate based on the mandatory components than higher income earners. This makes sense as a higher proportion of their expenditure is likely to represent essential items.
3. The distinction between net and gross earnings adds another complication. Given the tax-exempt benefits arising from superannuation for most Australian retirees, this is particularly relevant for the current Review.
4. The appropriate replacement rate will vary by household and there is not a single 'correct' answer. Whilst many households will need more income prior to retirement, when their family and housing costs may be higher, other households may have higher expenditure needs after retirement due to their lifestyle requirements and/or health costs. It should also be noted that an increasing number of Australian households are entering retirement with an ongoing debt such as a mortgage. Hence while family costs are likely to be lower, housing costs may not reduce. This fact also applies to the increasing number of renters.

Taking all these factors into account, we suggest that the desirable level of net replacement rates for Australian retirees should be at least 85 per cent for low income earners reducing to 60 per cent for very high income earners. These desirable levels could translate to somewhat lower net replacement rates provided by the mandatory components of the retirement income system (i.e. the Age Pension and compulsory superannuation) according to the following table:

Lifetime income level	Net replacement rate from the mandatory components
Low (50% of the average wage)	80% of income
Median (80% of the average income)	70% of income
Average (100% of the average income)	65% of income
High (200% of the average wage)	55% of income

These high level goals also need to considered in the light of the following commentary:

1. At this stage, these is no implied suggestion as to the balance between the age pension and compulsory superannuation at each income level.
2. For the moment, it is assumed the individual is a full time worker for approximately 40 years. Part time workers and those with periods out of the workforce require further consideration.
3. The definition of income used to determine the replacement rate is critical. For example, it could range from the average of an individual's lifetime income to the income earned in the final year of work. Realistically neither of these extremes are appropriate in determining an income related to an individual's living standards leading up to the retirement years. Hence,

we suggest that the revalued net income received in the ten years before receiving any pension or superannuation payment is a reasonable approach.

There is another critical point that is often overlooked in various models that consider the design of the Australian retirement income system. For simplicity, many models assume that the individual will retire at the pension eligibility age. However, this does not represent reality.

Many individuals retire from the labour force before the pension eligibility age for a variety of reasons. These reasons include retrenchment, voluntary redundancy, ill-health and the need to care for a partner or ageing parent. For example, the labour force participation rate at ages 60-64 is 58.6% compared to 74.8% for ages 55-59 and 83.3% for ages 50-54[12]. That is, almost one third of the individuals in the workforce at ages 50-54 are not in the workforce 10 years later. In brief, they have retired early. In some cases, they will be eligible for the Disability Support Pension or the much lower Newstart Allowance but in many other cases they will need to rely on their savings (including superannuation) or their partner's income.

The other variation amongst older workers is the relative increase in part time employment. For example, 73.3% of employed persons aged 45-54 have a full time role whereas this percentage drops to 61.3% and 42.0% for those aged 60-64 and 65 and over respectively.

Hence, when modelling the period when retirement income is needed, it is important to recognise that many retirees will need to draw down their superannuation for some years prior to the Age Pension eligibility age. In this respect it is also important to recognise that the future preservation age is 60, seven years earlier than the future pension eligibility age.

Observation

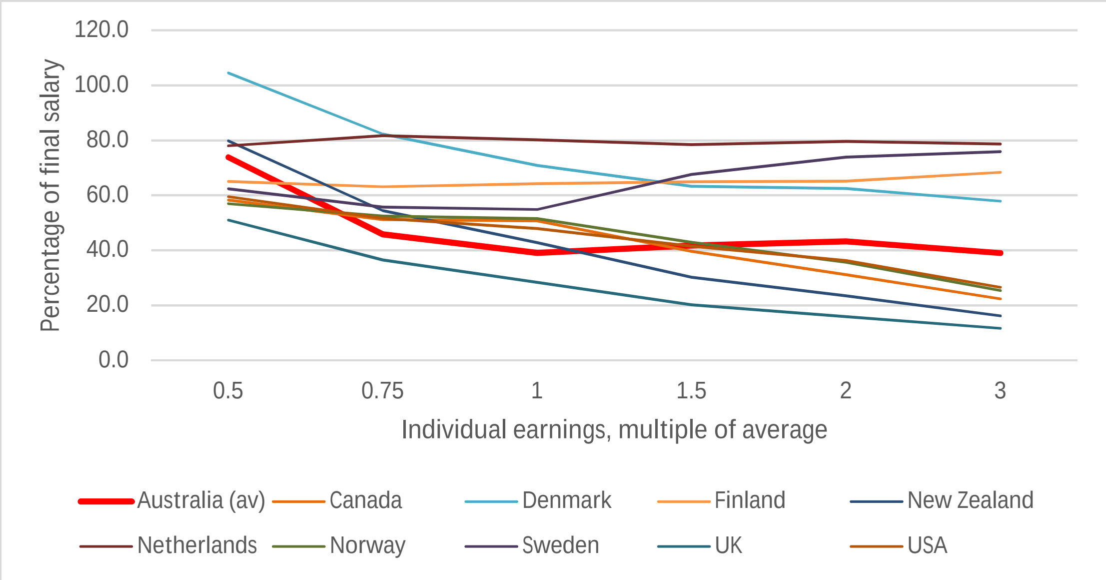
For simplicity, many models of the Australian retirement income system assume that a single individual will work full time and retire at the Age Pension eligibility age. However, this does not represent reality given the increasingly diverse career experiences within the workforce and that 70 per cent of individuals retire with a partner. It is essential that the Review consider a broad range of actual experience.

The World Bank's comments, as well as the above table, suggest that the targeted net replacement rate from mandated components should gradually decline as income increases. Indeed for OECD countries, the average net pension replacement rate for males decreases from 68.3% to 58.6% and 54.7% for incomes equal to 50%, 100% and 150% of the average wage respectively[13]. However, the current Australian system does not produce this result. Figure 2.2 shows the net replacement rates for the leading countries in the 2019 Melbourne Mercer Global Pension Index as well as several Anglo-Saxon countries for individuals with a full-time career from age 22 until the normal pension age.

[12] ABS (2019), Labour Force, Australia, May.

[13] OECD (2019), *Pensions at a Glance*, Table 5.5

Figure 2.2: Net pension replacement rates by earnings



Source: OECD (2019), *Pensions at a Glance*, Table 5.5

Most systems show a steady decline in the net replacement rate as incomes increase. There are two types of exceptions. First, Finland and the Netherlands have an almost constant replacement rate as incomes rise. Second, Australia and Sweden both show an increase in the replacement rate for incomes above the average. The reason for Sweden's result is the increasing effect of the private employer contribution for the funded defined contribution scheme which commences at wages above average earnings.

The unusual result for the Australian system is caused by the strong impact of the assets test for incomes below average earnings and the relatively flat superannuation tax regime compared to the progressive income tax system at above average incomes. This result stands in contrast to those systems which have an EET[14] pension tax regime where the pension tax is dependent on the benefits received. It is also recognised that the OECD modelling considers the income in the first year of retirement and the above pattern may not occur in later years as the means-tested Age Pension becomes more important.

The above result for Australia is not ideal and whilst the results may be reasonable for low and very high income earners with a full career, it does not represent a good outcome for median or average income earners.

Observation

The pattern of net replacement rates from the Australian system is unusual compared with other developed pension systems. As such, it does not deliver a desirable outcome for average or median income earners.

[14] EET stands for tax exemption for contributions and investment income but the benefits are taxable.

3

A REVIEW – HOW OUR SYSTEM STACKS UP

This chapter will initially consider the data available from the 2019 Melbourne Mercer Global Pension Index (MMGPI) and thereby highlight areas where the Australian system performs well, in addition to those areas where the system could be improved.

The MMGPI has three sub-indexes, namely adequacy, sustainability and integrity. Of course, two of these terms represent two of the four principles adopted by the Review, even if the perspectives may be slightly different.

A. ADEQUACY

The adequacy sub-index is primarily concerned with the provision of benefits to retirees, which is influenced by the level of social security benefits, the design of the occupational pension or superannuation system, the balance between mandatory and voluntary contributions, the investment allocation of pension funds, as well as savings outside the pension system and the level of home ownership.

The level of the minimum pension

Most civilised societies provide a minimum pension to the aged to alleviate poverty. As discussed in Chapter 2, the Australian Age Pension is relatively generous compared to many comparable countries. Hence the level of the Age Pension should not be a concern for the Review.

On the other hand, the interaction between the Age Pension and superannuation is very complex and needs to be simplified. This is further discussed in Chapter 7.

The net replacement rate

The Australian score relating to net replacement rates in the first year of retirement is only slightly above the average for the 37 systems in the 2019 MMGPI. The primary reason for this is the interaction of the means-tested age pension with the mandatory superannuation system. In particular, the strong assets test reduces the availability of the Age Pension for many retirees with relatively modest superannuation balances in the early years of their retirement.

As will be discussed throughout this submission, improved integration between the three pillars of our retirement income system should improve the net replacement rates for many retirees.

Of course, there is a valid debate whether the objectives of the system should be expressed in absolute terms (such as the ASFA Retirement Standards) or in relative terms relating to the living standards prior to retirement.

The MMGPI concentrates on net replacement rates as this data is available from the OECD and is consistent with our views of the overall objective outlined in Chapter 2. It is suggested that the concept of replacement rates is not as well established in Australia as in most other OECD countries.

The design of the superannuation system

The Australian system scores very well when the vesting, preservation and portability of superannuation benefits are considered. This strong position represents a significant improvement from 30 or 40 years ago when vesting scales were present in many superannuation plans and the requirement to preserve the superannuation benefit when an individual changed employment did not exist.

However, Australia scores poorly when the provision and design of income streams are considered. The Financial System Inquiry recommended the development of Comprehensive Income Products for Retirement (CIPRs) but this topic has gained limited traction in recent times.

Whilst the CIPR design may not be perfect, it is critical that the Australian superannuation system changes its focus from accumulation to the provision of retirement income. This topic will be further discussed in Chapter 5.

The asset allocation of the investments

The net investment performance of the assets held by superannuation (or pension) funds over many years represent a critical factor in determining the success of most retirement income systems. Australia has one of the highest exposures to growth assets in the world and these have performed well during recent years. The Australian superannuation industry has also diversified its investments across many asset classes and now has significant investments overseas. This is a positive outcome as it reduces reliance on the Australian economy and has been an important factor in improving Australia's current account balance.

However, there is a potential downside with this strong focus on growth assets. As the baby boomers retire, there may be an increase in the need for less volatile assets to support retirement income and provide longevity protection. Such products are not yet common, given the popularity of account-based pensions (see Chapter 5).

A financial market "crash" is inevitable at some time in the future and this will inevitably affect the value of assets held by many Australian retirees. A second-order effect of such an event would be to increase the cost of the Age Pension as many retirees will be in receipt of a part Age Pension or no Pension at all. The increasing cost of this potential scenario should be explored.

Voluntary savings and household debt

As noted in the Consultation Paper, part of Pillar 3 includes voluntary savings outside the superannuation system and home ownership. Both these factors can have an important bearing on the broader well-being of retirees.

The level of home ownership in Australia is gradually declining and is now slightly below the average of countries considered in the 2019 MMGPI.

Another important finding in the 2019 Report was the strong relationship found between accrued pension assets and net household debt, when both are expressed as a percentage of GDP. The Report suggested that as pension assets increase, consumers feel more financially secure and are therefore willing to enter into more debt. It is worth noting that this relationship was established across 37 retirement income systems and does not necessarily apply to any single economy. Hence, it is not appropriate to suggest a direct relationship between the superannuation system and housing affordability in Australia, as some have done. It is also worth noting that the statistical analysis suggests that for every extra dollar in pension assets, the level of net household debt increases by less than 50 per cent of this amount. That is, there is still an increase in funds available for retirement.

B. SUSTAINABILITY

The sustainability sub-index brings together several factors that affect the long-term sustainability of existing retirement income programs including the coverage of Pillar 2 arrangements, the level of pension assets, demography, pension eligibility ages, labour force participation amongst older workers and real economic growth.

Coverage

As would be expected with a compulsory system, Australia has much higher superannuation coverage of the working age population than many countries. However, as discussed in Chapter 4, the self-employed are not covered and this means our coverage is not as high as some countries such as Denmark, Finland, Iceland, the Netherlands and Sweden[15].

It is also worth noting that the percentage of the working-age population with a funded and private pension plan is likely to be higher than the proportion of individuals who are actively saving for retirement. For example, with the preservation rules applying in Australia, many individuals will have a superannuation account from past employment even though they may be out of the workforce at this time.

Size of superannuation assets

The growth of the level of superannuation assets in Australia over the last 20 years has been remarkable. Twenty years ago, the value of superannuation assets represented about 40 per cent of GDP whereas today it is approaching 150 per cent of GDP. These assets provide several benefits to the broader economy as well as providing greater security to members concerning their future retirement benefits.

Demography

Ageing populations, increasing life expectancies and declining fertility rates are placing increasing pressures on many retirement income systems around the world. Comparatively Australia is well placed and scores better in these questions than many European or North American countries. Some countries, such as the USA, score better due to their lower projected life expectancies whereas others, such as Denmark and the Netherlands, score better due to their plan to increase the pension eligibility age as life expectancy continues to rise.

Labour force participation

There are significant retirement income benefits that arise when individuals work a little bit longer. These include the making of extra contributions, additional investment returns especially as the superannuation account is near its peak and the consequential shortening of the retirement period which requires funding.

The labour force participation rate for those aged 55-64 in Australia has gradually increased during the last ten years from 57.2 per cent to 66.7 per cent. Whilst this represents a positive development, this participation rate is still below many countries including New Zealand (79.9%) and Sweden (81.6%)[16].

---

[15] OECD, *Pensions at a Glance 2019,* p 207

[16] International Labour Organization (2019), www.ilo.org.

These rates also highlight the fact that many individuals retire before the Age Pension eligibility age and therefore require government support or self-funding during these years.

Real economic growth

Increasing real economic growth is likely to improve the sustainability of retirement income systems through increased levels of employment, higher rates of saving, improved investment returns and the ability of governments to provide increased social security benefits. Australia's recent real economic growth has been positive and ahead of most OECD countries.

C. INTEGRITY

The integrity sub-index considers the role of regulation and governance, the protection provided to plan members and the level of communication that is required to be provided to members.

Observation

Australia performs relatively well in this sub-index with a ranking of fifth out of 37 systems. The major shortcoming is the absence of any requirement to provide benefit projections to members as part of their annual statement.

D. THE PRODUCTIVITY COMMISSION REPORT

The Productivity Commission's Report entitled *Superannuation: Assessing Efficiency and Competition* published in December 2018 represented an important report for the superannuation industry. It highlighted two structural flaws in the industry[17], namely unintended multiple accounts and entrenched underperformers.

It needs to be recognised that both of these issues are now being addressed through several measures including:

- The transfer of inactive accounts to the ATO
- Enabling the ATO to transfer these inactive accounts to the individual's current active superannuation account
- The recommendation from both the Productivity Commission and the recent Royal Commission for the establishment of a single default for each individual
- The publication by APRA of a heat map which highlights funds which have poor investment performance or excessive fees
- The introduction of the annual member outcomes assessment by all superannuation funds, together with a stronger focus by APRA on member outcomes

Whilst the Government and industry have not yet fully implemented all the relevant recommendations, it should be recognised that the industry is on track to considerably reduce the number of unintended multiple accounts as well as to improve performance in light of the growing pressure of APRA on fund trustees.

Therefore, we recommend that the Review does not revisit these issues.

---

[17] Productivity Commission (2018), *Superannuation: Assessing Efficiency and Competitiveness,* Overview, p2.

E. CONCLUSION

The 2019 MMGPI ranked the Australian retirement system third when compared with 37 retirement income systems. This is a good result and recognises that, whilst not perfect, the current system has many strengths. This should not be overlooked.

We believe the major weaknesses relate to:

- The lack of superannuation coverage in parts of the workforce, which will be discussed in Chapter 4
- The lack of a strong focus on retirement income, as distinct from accumulation, which will be discussed in Chapter 5, together with the need to provide income projections to members
- The need to simplify the current means testing arrangements, provide accessible financial advice and tackle the gender gap relating to superannuation, which will be discussed in Chapter 6
- The lack of any clear and simple integration or cohesion between the pillars, which will be discussed in Chapter 7

These developments will improve the benefits provided by the Australian retirement income system and could lift Australia to the coveted A-grade ranking within a future MMGPI.

4

COMPULSORY SUPERANNUATION COVERAGE

It is often assumed that the mandatory Australian superannuation system covers all workers. This is not the case. There are many reasons why some workers are not required to receive or make a superannuation contribution. These include:

- The employee earns a gross income of less than $450 in a month from an employer
- The employee is under age 18 or is classified as a private or domestic worker and has worked for less than 30 hours per week
- The individual is self-employed

There are also other cases where the employer does not pay the Superannuation Guarantee (SG) even where they are required to do so. However, the importance of these missing SG contributions is likely to reduce with the implementation of Single Touch Payroll and associated measures.

A. THE "UNSUPERED"

In early 2019, Mercer carried out research to determine the size of the unsupered workforce. Based on the ATO's two per cent sample file from their 2015/16 records, we determined that 8.7 per cent of the Australian workforce who earned at least $8,000 in the year from salary or wages and were aged under 70 did not receive or make any superannuation contributions during the 2015/16 financial year. This is equivalent to 1 in 11 workers or almost one million working Australians being unsupered. The threshold of $8,000 was applied to remove those who were earning less than $450 per month and an allowance for others who may have multiple jobs with low incomes. If this threshold was not applied, the number of unsupered workers would increase significantly.

The research showed that

- 57% of the Unsupered were self-employed
- 43% of the Unsupered were salaried workers eligible for the SG
- 33% of the Unsupered had a yearly income between $20,000 and $40,000
- The ages of the Unsupered were spread from under 20 to age 70. However most of the Unsupered were in peak earning years, namely from ages 30 to 54.
- The probability of being Unsupered decreases as income increases. For example, the probability of the self-employed being Unsupered decreased from 73% for incomes between $8,000 and $20,000 to 37% for incomes above $120,000. The corresponding percentages for salaried workers decreased from 11% to 2%.

The OECD has noted that only 27 per cent of the self-employed made contributions in 2016-17.[18] Whilst in some cases, this represents the deliberate choice of the self-employed, there are other cases where the self-employed were uninformed or disinterested.

This research also considered the level of superannuation contributions actually received. Whilst the Unsupered (or 8.7% of the sample) received no contributions, a further 5.4% of workers received contributions less than 4% of their income. In addition, 15.4% of workers received contributions between 4% and 8% of their income.

[18] OECD, *Pensions at a Glance, 2019,* p115

In other words, more than one fifth of the sample received contributions, but at a level less than the required SG level. Part of this shortfall is likely to be caused by the distinction between the self-employed, contractors and employees and because income earners who work in a range of circumstances receive SG contributions for part but not all of their earned income. In addition, the SG is not paid on overtime earnings.

B. THE $450 THRESHOLD

Since the commencement of the SG in July 1992, employers have not been required to make SG contributions for employees who have earned less than $450 per month. In 1992-93, this was equivalent to the income tax free threshold of $5,400. The SG threshold has not changed since the SG commenced.

One of the reasons for the threshold was to simplify administration. In a paper-based economy, this made sense. However, in today's digital economy, this rationale no longer holds. Indeed, some employers with low-income casual staff do not apply the threshold as it is simpler, and considered fairer, to pay the SG to all staff. Indeed, it has been previously estimated that about 60 per cent of employees earning less than $450 per month receive the SG.

On the other hand, anecdotal evidence suggests that some employers deliberately adjust their casuals roster to limit the number of staff who earn more than $450 per month and thereby reduce their superannuation costs.

It is time to gradually remove the threshold to ensure that all employees receive the compulsory superannuation contributions.

Over time, there have been arguments presented not to reduce or remove this threshold. The two main arguments are discussed below with relevant comments.

- It would generate a large number of small balances which would be largely eroded by fees and charges.
  - Whilst the development of small accounts has been an issue in the past, the implementation of *Protecting Your Super* and *Putting Members' Interests First* will reduce the impact of administration and insurance costs for many of these employees as well as reducing the number of inactive accounts that are gradually eroded with fees.
  - In addition, the introduction of a single default account for each individual, as recommended by both the Productivity Commission and Royal Commission, will reduce the number of small accounts.
- Abolishing the threshold would increase the cost for employers, particularly in respect of their casualised workforces.
  - The payment of the SG contribution would inevitably increase the cost for some employers, although it has been estimated that the national wage bill will increase by less than 0.1 per cent. However, it would also remove the current incentive for some employers to deliberately adjust their rosters and so reduce their superannuation costs. Removing the threshold would also improve fairness as many more employees would then receive the benefit.

There are several other reasons to remove the threshold:

- About sixty percent of affected employees are females. Therefore, removing the threshold would have a positive impact on gender equity.
- Many casual workers receive the SG in some months and not in other months. For example, a casual worker at a sports stadium is likely to receive the SG in the football season when

there are many matches in each month but unlikely to receive it during the cricket season when there are fewer matches. Therefore, the current system mitigates the ability of these employees to build a reasonable superannuation balance.

- An increasing number of workers have multiple jobs. For example, it has been estimated than one million Australians have two or more jobs. Ensuring that all workers receive the SG contribution on all their jobs will improve their superannuation balances.
- As discussed in the next section, the labour force will continue to evolve with the growth of non-standard workers. Previously, this development would have led to an increasing number of small accounts. However, with the advent of recent Government legislation and the likely introduction of a single default, this outcome is now unlikely.

Given these developing circumstances we strongly advocate the removal of the $450 threshold. We believe this would:

- Increase superannuation balances for many low income workers
- Improve fairness in the system as almost all employees would be receiving the SG
- Simplify the system
- Help reduce the gender gap in superannuation
- Increase the level of public confidence in the superannuation system

C. NON-STANDARD WORKERS

Traditionally most superannuation and pension arrangements have been designed for full-time employees with 30 or 40 years of stable service. With full vesting of the SG contributions, preservation and improved portability, the Australian system is now more flexible than previously. Nevertheless, much of the modelling carried out by many commentators for public policy discussion continues to be based on full time workers working through to the Age Pension eligibility age. Given the increasingly diverse career experiences within the labour force, this approach is no longer valid.

As the OECD notes, globalisation, automation and demographic changes are transforming labour markets at a rapid pace, potentially leading to an expansion of non-standard work[19]. Non-standard workers are defined as those not covered by full time open-ended contracts, i.e. part-time, temporary or self-employed workers; in particular, those undertaking new forms of work. Non-standard employment already accounts for more than one-third of employment in OECD countries. Furthermore, changing technology and new work-based contracts make the boundary between employment and self-employment less clear than previously.

In November 2019, the McKell Institute issued a report, *Opportunities in Change: Responding to the Future of Work*, which explores the current state of the Australian labour market, the evolution of traditional employment and how government and industry can respond to the changing nature of work. To quote from the report[20]

> "The emergence of new technologies has dramatically impacted the way we live, work and produce. … But it's not just technology impacting the future of work. The nature of employment is also changing. Today, over one million Australians are employed as independent contractors. More than 100,000 of those are full time in the 'gig economy'. Even more shift between jobs, with labour mobility at an all-time high, and more than 40 per cent of millennials report having engaged in some form of freelance work.

---

[19] OECD, *Pensions at a Glance, 2019,* p66

[20] McKell Institute (2019), *Opportunities in Change: Responding to the Future of Work*

> If the future of work builds on these trends, the Australian labour market of tomorrow will be more flexible, more mobile, and more technologically-attuned than in the past. However, it may also be subject to higher rates of job insecurity, and reduced access to basic entitlements like superannuation and paid leave, if reforms are not delivered."

An obvious starting point in this discussion is to consider the treatment of the self-employed within the retirement income system. The OECD notes that the self-employed tend to have lower old-age income than former employees in many countries[21]. A common argument is that the self-employed need less pension provision due to additional private savings, including the value of their business. However, the OECD suggests that their median value of assets is only slightly higher than for employees.

The involvement of the self-employed in mandatory pension arrangements schemes varies considerably between countries. According to the OECD, there are only four OECD member countries where there are no mandatory pension contributions for the self-employed. These are Australia, Denmark, Germany and Mexico[22].

Whilst there are a variety of methods of including the self-employed in pension arrangements, the absence of many self-employed workers from the Australian superannuation system represents a significant shortcoming. Whilst some have argued that the value of their business represents assets or capital to fund their retirement, it must be recognised there are many self-employed workers who have a business with little or no value. The OECD is definite when it comes to the argument that the self-employed should not contribute to pensions due to their other assets. "Such arguments should be rejected."[23]

When comparing the contribution rates for pensions or social security paid by employees (or dependent workers) and the self-employed and the resulting pension entitlements, the OECD comments that:

> "Australia stands out as the means-tested basic pension (Age Pension) gives the self-employed 90% of what average wage employees get from mandatory earnings-related schemes (Superannuation)."[24]

In other words, the employee who earns the average wage has 9.5% of their earnings set aside for future retirement income. This stands in contrast to the self-employed, many of whom will rely on the Government during their retirement as they will have very limited financial resources from their business or elsewhere.

The goal should be to ensure an adequate level of retirement income (as discussed in Chapter 2) for all workers, irrespective of their actual employment arrangements, as well as the provision of clear incentives to improve their pension provision.

---

[21] OECD, *Pensions at a Glance, 2019*, p74

[22] Ibid, p82

[23] Ibid, p96

[24] Ibid, p87

Observation

The workforce is changing with increasing diversity. The current SG arrangements do not cater for the increasing importance of non-standard workers.

D. CONCLUSION

Mercer's recommendation is that all workers (or their employers) should be required to set aside a portion of their earnings into the funded superannuation system. This will have several benefits including:

- The extension of superannuation coverage to a significant proportion of the workforce who are currently missing out (ie. the unsupered)
- Improved retirement benefits for many workers which, in turn, should help maintain their living standards after retirement
- The removal of the current confusion in terms of superannuation coverage for the self-employed, gig workers, contractors and employees
- The removal of the current inequity between those earning above and below $450 per month
- Improved job mobility between different types of workers as there would be no superannuation disparity

As the OECD concludes:

> "there are good arguments in favour of harmonising pension rules broadly between dependent and independent workers."[25]

Of course, the extension of mandatory superannuation to the self-employed and some other workers would require consideration of appropriate transition arrangements and the income base to be used in the calculations. However, given that the Australian system has no mandatory employee contributions and is predominantly a DC system, these questions should be easier to resolve than in many other countries.

[25] Ibid, p96

5

RETIREMENT INCOME – ATTITUDES, ACTIONS AND ASPIRATIONS

This chapter will focus on the provision of retirement income which, after all, should be the culmination and focus of any retirement income system. We will begin by sharing the results of three Mercer studies about the attitudes of retirees and pre-retirees. We will then look at the behaviour of account-based pension holders and how this varies by account balance. Finally, we will assess what is currently working and not working before making some suggestions for improvements to the provision of retirement income.

A. ATTITUDES- WHAT MEMBERS WANT

Mercer has recently undertaken two large surveys and a smaller qualitative study to better understand the wants and needs of retirees. This has given us much greater insight into attitudes and behaviours amongst Australian retirees and pre-retirees. The themes and findings across the three studies were consistent which, in turn, provides a good foundation for recommendations concerning the future.

The methodology of the three studies:

1. An online survey in November 2018 of more than 1,000 Australians aged 55 and over. All respondents had a superannuation balance of more than $50,000 to ensure super would be a significant part of their monetary support through retirement.[26]
2. An online survey in July 2019 of 845 Mercer Super Trust (MST) members aged 50 and over with a broad distribution of superannuation balances.
3. One-to-one interviews in October 2019 with 15 Australians aged 55 and over with superannuation balances of between $200,000 and $1 million.

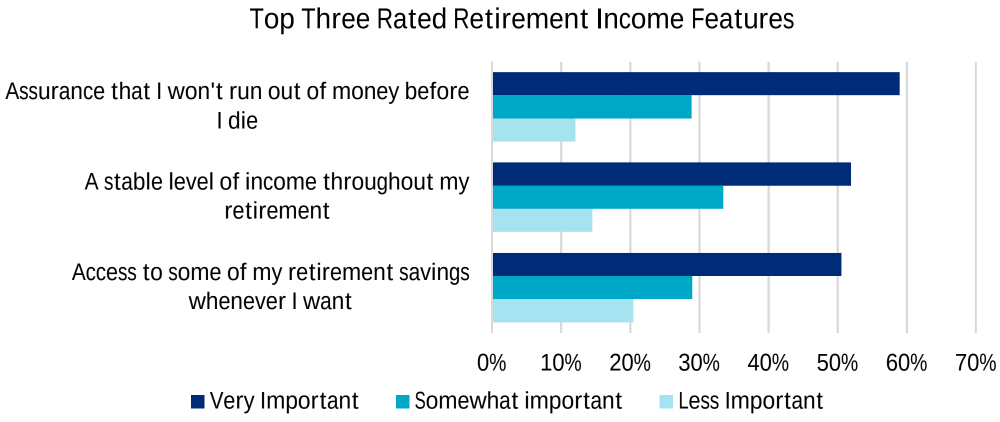
There were two key themes.

1. The Need for Certainty and Flexibility

Our first study of the broader Australian population found that the top three features desired by retirees were

- assurance that their money won't run out;
- a stable level of income throughout retirement; and
- access to some of their savings whenever they want it.

[26] Mercer (2019), *Great Expectations – Attitudes and Behaviours amongst Australian Retirees* https://www.mercer.com.au/our-thinking/superannuation/great-expectations-attitudes-and-behaviours-amongst-australian-retirees.html

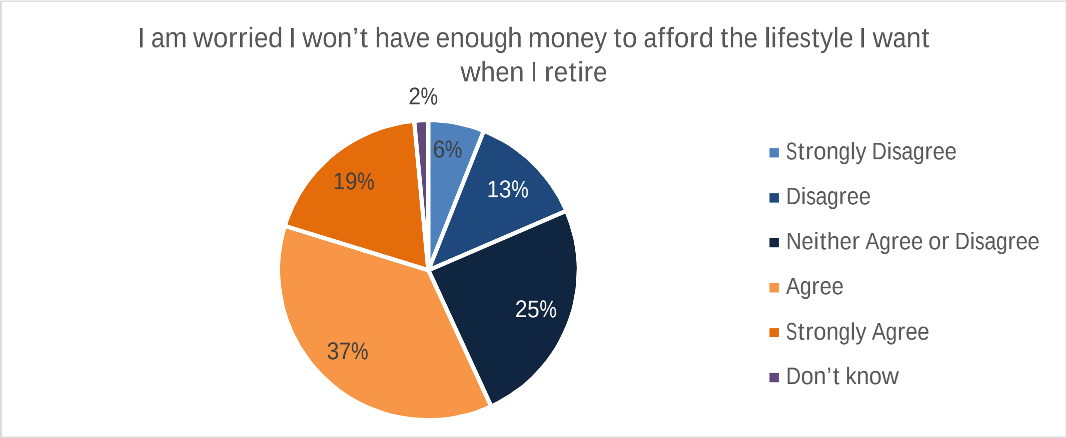


In our second study of MST members, we asked them how much they agreed or disagreed with several statements. They resulted in very similar findings with the following table showing the statements that resonated most.

Topic	**Percentage who somewhat or strongly agreed**
I want to ensure any retirement investments I have will go to a family member / loved one in the event of my death	89%
Having a regular monthly income even after I retire is important to me	87%
I need flexibility to change the amount of money I receive from my retirement savings over time	71%
I am worried about the impact inflation may have on my retirement	64%
I would prefer a guaranteed retirement income stream for life (regardless of how long I live) – even if it means the amount I receive is a bit lower than it would be if it weren't 'guaranteed for life'	51%

There is a clear desire for certainty as well as flexibility.

Supporting the need for certainty was the finding that 56% of these older superannuation fund members were worried that they wouldn't have enough money to afford the lifestyle they want in retirement.

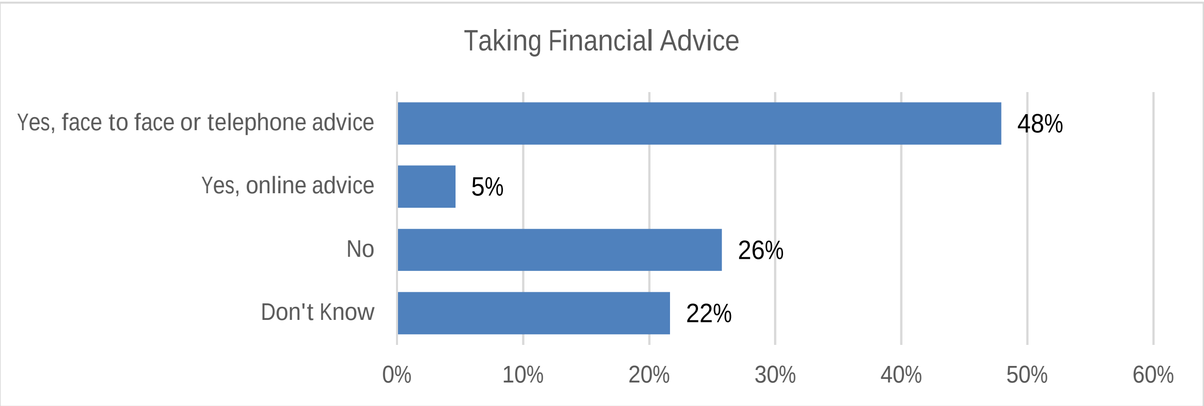


This attitude was underpinned by the one-on-one interviews. No one was worried about not spending enough of their retirement savings to enjoy a good lifestyle but many were worried about having enough money to be comfortable. There was a clear tension between not being restricted by the shortage of money and the sensible risk-averse approach adopted by many retirees to be careful. This approach is understandable as there are so many variables and uncertainties when one is considering the next 20 or 30 years – the retiree just don't know what's going to happen. This tension is summed up by the following quote:

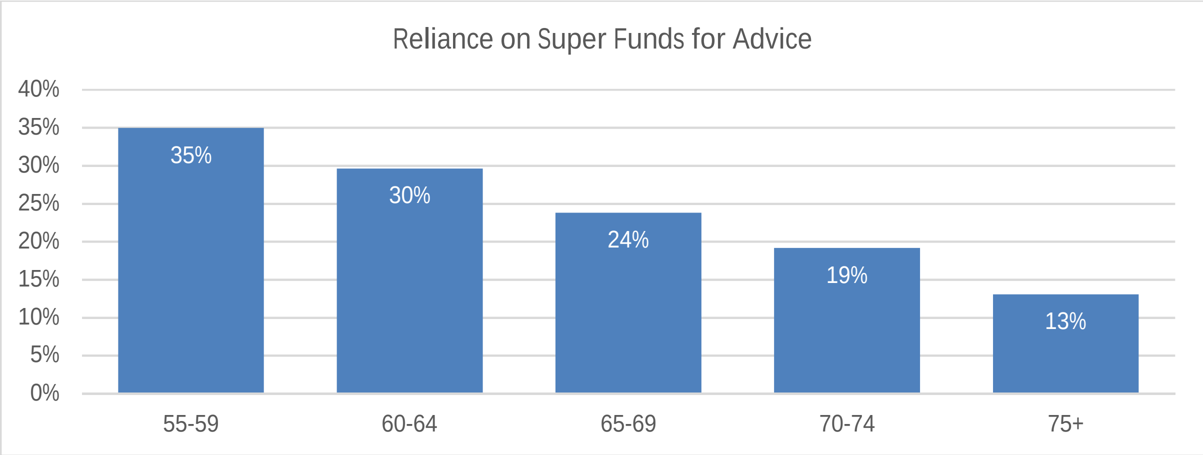
> "I don't want my lifestyle to suffer, I don't want to have to worry about money."

2. The need for advice to make the right decisions

In our first survey, we found 53% of retirees wanted advice, however, there was also a large portion (48%) who were undecided or didn't plan to seek support from a financial adviser.

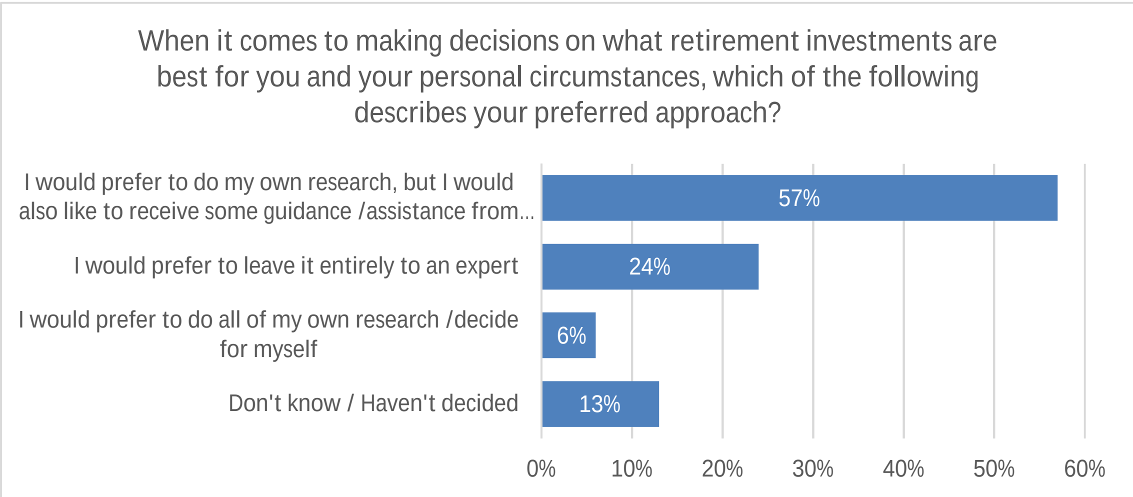


We then asked those respondents that planned to get advice, from whom would they would seek advice. As expected, the majority turn to a financial adviser, however, there was an interesting trend of an increasing number of younger people expecting to get the advice from their superannuation fund. With a maturing superannuation industry, this is perhaps to be expected.



It's very understandable that retirees want advice, particularly given the complexity of the current system, but independent financial advice is expensive and 70% of our working respondents were not willing to pay more than $1,000. This is significantly lower than the average $2,435 to prepare a Statement of Advice for new clients and $3,354 per year for ongoing advice for clients[27].

Given the importance of this area, we delved into it again in our second study where we asked respondents how they preferred to be assisted with decisions regarding retirement investments. Only 6% wanted to do it all themselves. The majority wanted to understand the decisions they were making but have some guidance or help from an expert.



In the qualitative study, the overall sentiment towards financial planners was 'only if you have to'. They didn't trust that the information would be unbiased; they felt they were just being sold to. They also lacked confidence in the ability of advisers to understand their needs which led to a fear of losing control and not being in a position to make their own decisions.

Fees are a clear barrier to accessing advice with respondents finding them hard to justify. There was, however, recognition that planners can bring a level of expertise to the conversation as they have access to all the relevant information.

---

[27] Financial Planning Association of Australia (2018), CoreData FPA Member Research

Currently there is a tension in the provision of financial advice. On one hand, there is the understandable need for financial advisers to “know your client” and so provide holistic and comprehensive advice. On the other hand, intra-fund advice provided by superannuation funds is restricted and cannot provide comprehensive advice. Yet it is this source of advice that is often received by low and middle earners, as financial advisers tend to ignore this section of the market. A better solution is needed where general advice, together with some core principles, is available to all retirees.

Observation

Most retirees require some help in their financial planning for retirement. However, they are reluctant to pay for a full financial plan.

New approaches to financial advice are needed to ensure that all retirees have access to affordable, sound and trusted financial advice. This could include extending the remit of intra-fund advice which is currently fairly limited. It could also include broader use of better online tools or robo-advice.

B. ACTIONS – WHAT RETIREES ACTUALLY DO

As is well known, account-based pensions (ABP) are by far the most popular retirement income product in Australia. There are many reasons for this popularity, including:

- The investment income and benefit payments are tax exempt
- Lump sum withdrawals are available, thereby providing retirees with great flexibility relating to their expenditure and, in some cases, their application for the Age Pension
- Investors can readily adjust their asset allocation as financial markets or their risk profile change
- The regular income payments can be paid on a cycle chosen by the retiree, ranging from fortnightly to annually
- The minimum drawdown rates do not represent a significant imposition for most retirees
- The concept of an ABP is relatively simple to understand as it is the reverse of an accumulation or bank account

In framing the most appropriate public policy for developing the best retirement income products, it is useful to consider the actual behaviour of current retirees with ABPs.

The following analysis considers the behaviour of 2,518 retirees in the Mercer Super Trust as at 1 July 2019 who have invested in an ABP with total assets of $945.5 million at that date. That is, an average balance of $375,512 with a median value of $243,508.

Table 5.1 shows the breakdown of the pensioners by age and account balance. As may be expected, most investors have balances less than $500,000 and are aged between 60 and 75.

Table 5.1: A breakdown of the membership in this analysis

	Account balance as at 1 July 2019								
Age	<100k	100-200k	200-300k	300-400k	400-500k	500-750k	750-1000k	>1000k	**Total**
Under 60	1%	1%	1%	0%	0%	1%	1%	1%	**5%**
60-64	4%	5%	4%	3%	2%	4%	2%	2%	**25%**
65-69	7%	8%	5%	4%	3%	4%	2%	3%	**37%**
70-74	5%	6%	3%	2%	2%	3%	1%	2%	**23%**
75-79	3%	2%	1%	1%	0%	0%	0%	0%	**8%**
80 and over	1%	1%	0%	0%	0%	0%	0%	0%	**3%**
Total	**21%**	**23%**	**14%**	**9%**	**7%**	**13%**	**6%**	**8%**	**100%**

This analysis explores the behaviour of these retirees and, in particular, the nominated withdrawal rate for their regular income payments. That is, we are ignoring any ad hoc lump sum payments. The regulations prescribe a minimum withdrawal rate, expressed as a percentage of the account balance at the start of the financial year. These minimum withdrawal rates range from 4% for those under age 65 to 14% for those aged 95 and over.

This research analyses the choice made by each investor with reference to these minimum annual payments. For example, if the investor chooses the minimum rate we have expressed this as zero per cent; in other words, there is no additional benefit paid. If they have selected a withdrawal rate of 5.5% when the minimum is 5% we show this as an extra benefit in the 0.01-1% range.

Table 5.2 shows the percentage of all investors with different balances and the nominated selection for their regular income payments relative to the minimum drawdown rules. The table shows that more than 50 per cent of members have selected an income stream that is either at the minimum or no more than 1 per cent above this minimum. On the other hand, 27 per cent of members have chosen an income that is more than 5 per cent of their account balance higher than required.

However, it must be noted that these higher drawdown rates are concentrated amongst retirees with smaller balances. That is, there are significant differences in the behaviour according to account balances; those with higher balances withdraw a smaller percentage of their balance. The research shows no material behavioural differences according to age.

Table 5,2: A breakdown of the behaviour by number of members

	Account balance								
Extra benefit	<100k	100-200k	200-300k	300-400k	400-500k	500-750k	750-1000k	>1000k	**Total**
0%	5%	9%	5%	4%	3%	6%	3%	5%	**39%**
0.01-1%	2%	3%	2%	1%	1%	2%	1%	1%	**13%**
1.01-2%	1%	1%	1%	1%	1%	1%	1%	1%	**6%**
2.01-3%	1%	1%	1%	1%	1%	1%	0%	0%	**6%**
3.01-4%	1%	1%	1%	0%	1%	1%	0%	0%	**5%**
4.01-5%	1%	1%	1%	0%	0%	1%	0%	0%	**4%**
More than 5%	12%	7%	3%	2%	1%	1%	0%	0%	**27%**
Total	**21%**	**23%**	**14%**	**9%**	**7%**	**13%**	**6%**	**8%**	**100%**

Given the material difference in behaviour by account balance, Table 5.3 shows the percentages if the behaviour is weighted by account balance and not members; that is, giving greater weight to those with more funds. This analysis shows that 49 per cent of the funds are withdrawn at the minimum rate with a further 24 per cent withdrawn at a rate that is no more than 2 per cent above the minimum.

Table 5.3: A breakdown of the behaviour by assets

	Account balance								
Extra benefit	<100k	100-200k	200-300k	300-400k	400-500k	500-750k	750-1000k	>1000k	**Total**
0%	1%	3%	3%	3%	3%	9%	7%	20%	**49%**
0.01-1%	0%	1%	1%	1%	1%	3%	3%	5%	**16%**
1.01-2%	0%	0%	1%	1%	1%	2%	2%	2%	**8%**
2.01-3%	0%	0%	1%	1%	1%	2%	1%	1%	**7%**
3.01-4%	0%	0%	0%	0%	1%	1%	1%	1%	**5%**
4.01-5%	0%	0%	1%	0%	1%	1%	0%	0%	**3%**
More than 5%	2%	3%	2%	2%	1%	2%	0%	0%	**12%**
Total	**3%**	**9%**	**9%**	**8%**	**9%**	**20%**	**14%**	**28%**	**100%**

To provide greater insights into the behaviour of retirees with different balances, Table 5.4 shows the behaviour for each account balance group rather than for the total sample.

Table 5.4: A breakdown of the behaviour by members for each account size

	Account balance							
Extra benefit	<100k	100-200k	200-300k	300-400k	400-500k	500-750k	750-1000k	>1000k
0%	22%	39%	37%	39%	37%	45%	49%	68%
0.01-1%	8%	12%	11%	12%	14%	17%	20%	16%
1.01-2%	3%	5%	8%	8%	8%	8%	13%	6%
2.01-3%	3%	5%	8%	9%	9%	10%	8%	3%
3.01-4%	2%	4%	5%	5%	10%	7%	7%	3%
4.01-5%	3%	4%	7%	3%	6%	4%	1%	2%
More than 5%	58%	31%	24%	24%	16%	10%	2%	1%
Total	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

As previously suggested, the importance of the minimum increases as the balance rises or, to put it another way, those with smaller balances are using up their superannuation balances at a relatively faster rate. This is reasonable behaviour given their balances are smaller and that most of these retirees are likely to rely heavily on the Age Pension in future years, although this will depend on the financial position of any partner.

However, as available superannuation balances at retirement are likely to increase significantly in future years, it is the behaviour of retirees with balances between say $300,000 and $1 million that is instructive for the framing of public policy.

For most of these retirees, the presence of the minimum drawdown rate is very important in their decision making. That is, it provides an “anchor” for their behaviour. Furthermore, most of these retirees are likely to receive only a part Age Pension in future years and hence they are adopting a conservative approach towards their expenditure. As mentioned above, the future retirement years represent many unknowns and hence, most retirees withdraw at or near the minimum rate prescribed by government.

Observation

Government rules influence the behaviour of retirees even when the only rule is a minimum drawdown rate. A greater range of suggested drawdown rates, as distinct from just the minima, together with improved education, could lead to less conservative behaviour.

C. ASPIRATIONS – OTHER INCOME SOURCES

As we consider the retirement products now available, there are a number of areas working well which are meeting the needs of retirees, such as:

1. The flexibility to take benefits in both lump sum and income forms
2. The flexibility of account-based pensions
3. The minimum income provided by the Age Pension, although it is noted that the current level is insufficient for many of those renting in the private market
4. The ability to pass on savings to loved ones, particularly partners

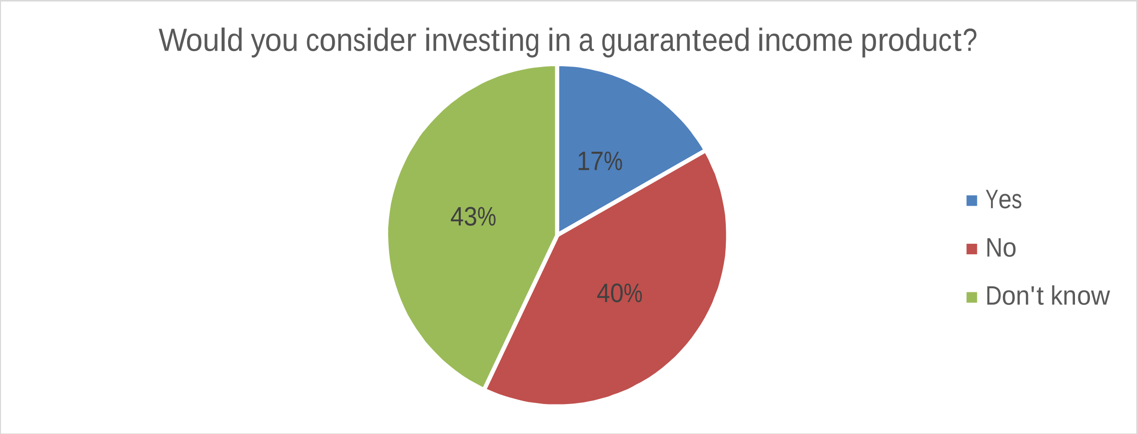
However, there are two areas highlighted by our surveys where there is still room for improvement and ongoing development concerning future products that can provide regular income.

1. Guaranteed income products for life

The studies have shown that retirees have a strong preference for a stable level of income that will last their lifetime without having to take on too much investment risk. The mechanisms for retirees to achieve this outcome are currently incomplete, inefficient and not well communicated, making it difficult for retirees to form optimal retirement plans, implement solutions and achieve the best retirement outcomes according to their goals and preferences.

Within the current superannuation system, the logical path for many retirees would be to include a form of longevity protection within their retirement income solution. This is because no one knows how long their savings will need to pay an income for, and longevity protection can provide assurance against running out of money later in life. The Age Pension is an A-grade example of longevity protection although it is not sufficient for many retirees to maintain their lifestyles.

Despite this obvious need, less than 20% of our survey respondents were willing to consider guaranteed income products.



This low level of interest or awareness may be due to a number of factors.

An important one is the Age Pension which (in effect) is a government-provided indexed longevity product. With its value for a single person at the pension eligibility age in the order of $500,000, it is understandable why many retirees do not appreciate the need for additional longevity protection. Of course, the level of the Age Pension is modest and many retirees may benefit from additional longevity protection to secure their future lifestyle.

Other factors that impede the development of longevity and related products include:

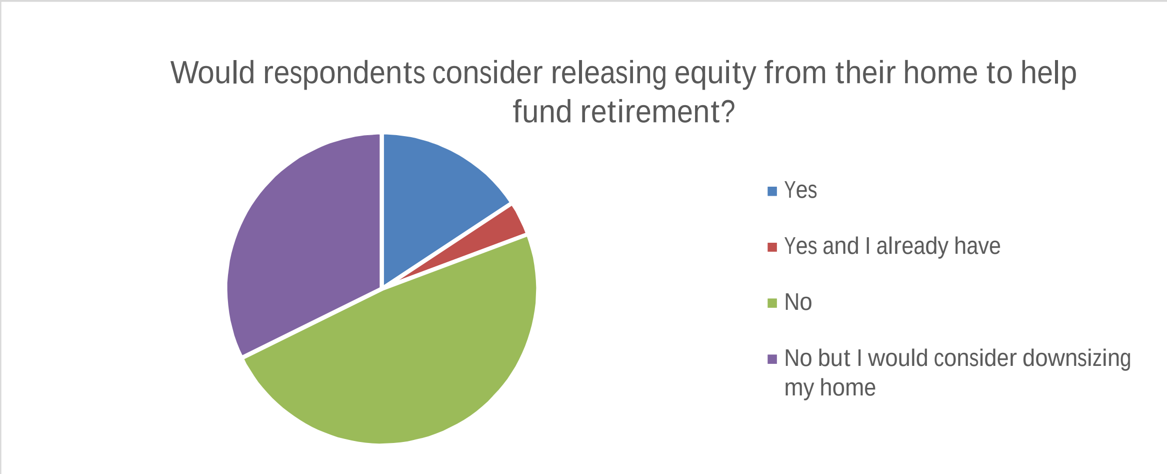
- The short-term focus of retirees and the associated underestimation of their life expectancies
- Concern by retirees that these funds are not accessible and could be lost in the case of an early death
- Superannuation funds may be reluctant to encourage such products where they involve assets flowing to other providers
- The relatively few number of financial advisers who understand these products and are comfortable including them in client portfolios
- Some financial advisers who wish to maintain more assets under advice
- The current historically low interest rates which would be locked-in with some longevity products
- The absence of any immediate need for fund trustees to tackle the issue

Complexity is also a key consideration; particularly when it comes to incorporating them into an overall retirement portfolio. It is not easy for retirees to understand how these products interact with and complement other products, such as the Age Pension (which may increase in relative importance over time for many retirees) and account-based pensions.

2. Equity release schemes

We also explored the other important source of wealth, outside of superannuation, which could form part of a person's income in retirement; namely, the family home.

The home is the largest asset held by Australians, accounting for an average value of $500,600 or 42 per cent of total household assets. This increases to 57 per cent when the value of other owned property is considered. This compares to $213,700 or 18 per cent for superannuation, the second largest asset[28]. As the home makes up such a large portion of overall wealth for so many, we questioned whether our respondents had considered using this to help fund their retirement. The answer was an overwhelmingly no.



Responses varied by age, with younger people being slightly more willing to consider equity release as an option. Interestingly, this result did not vary by superannuation balance. Respondents with less than $200,000 in superannuation stated they were just as likely to consider equity release as an option as those with more than $750,000, even though those with smaller balances may be more likely to need it.

D. ASPIRATIONS – PROVIDING AN IMPROVED ENVIRONMENT FOR RETIREES

Whilst the previous section discussed two alternative sources of retirement income, we will now present four ways to improve the Australian retirement income system and so generate better outcomes for retirees.

Better Tools and Guidance

Our MST quantitative study established a clear need for better tools and guidance. For example:

- 78 per cent of members want a tool to help them decide which retirement solution is best for them.
- 73 per cent of members want a tool to help them understand their Age Pension eligibility, which confirms the complexity of the current means tests.

[28] ABS (2019), Household Income and Wealth, Australia, 2017-18

- 72 per cent of members want a tool to help them budget and work out how much money they will need to meet their retirement goals.
- 57 per cent of members prefer some guidance or assistance from an expert to supplement their own research. Only 6 per cent wanted to do it all by themselves.
- Only 21 per cent of members felt comfortable applying for a retirement product without assistance. This confirms the complexity of transitioning from accumulation to the pension phase.

The qualitative research also indicated a demand for better tools and guidance. Throughout this research we were constantly reminded how foreign and obscure are much of the superannuation language, concepts and ideas associated with retirement. It was also apparent that there was a huge amount of educating required to help empower people through this experience.

The table below highlights some of the pain points from our respondents.

Topic	Quotation
Tax and Regulation	"What is the process? Is tax applicable at retirement? Are you obliged to take your superannuation at retirement?"
Transitioning into Retirement	"But how do I get it (the money) from my super?"
Turning super into an income	"I don't want my lifestyle to suffer. I don't want to worry about money."
Need for reassurance	"I don't want some young person telling me what to do. I want to hear who have been through it, who understand the experience."

The concerns of these members are not surprising. The Australian retirement income system is incredibly complex. It must be simplified. This evidence highlights the need for better engagement, clearer information and the provision of readily accessible guidance and advice.

In order to be successful we need to put ourselves in the situation of the individuals and households going through the process and remember that retirees only do this once – they will not have prior experience they can fall back on.

Longevity Products

As discussed above, there is a need for longevity products to form part of the solution for many retirees. However, individuals are often reluctant to invest in these products.

The Government has acknowledged this reluctance and, as a first step, has introduced legislation to amend the age pension means test rules for eligible longevity products. These changes came into effect from 1 July 2019 and provide retirees with a modest Age Pension incentive if they allocate some of their assets to a qualifying longevity product. However, this will only impact behaviour if retirees are aware of the benefits and are able to access these types of product with ease.

Superannuation funds need to better educate and engage their members on the different longevity products available, how they might help them maintain income longer in retirement, and make them more available. Accessibility can be improved by building well-thought out engagement journeys, which lead to retirement income solutions combining longevity protection with an account-based pension.

In the 2018 budget the Government announced that it would introduce the Retirement Income Covenant which would require trustees to consider a range of factors in the development of their retirement products. Unfortunately, this has not yet proceeded. The introduction of this covenant into the SIS Act would provide trustees with a requirement to have a greater focus on the provision of appropriate income products for their members.

It is important to note that there will not be a one-size-fits-all. Retirees are not all the same when it comes to factors such as health, the availability of other income sources, home ownership, marital status, desired lifestyle, etc. There will be circumstances where it does not make sense for retirees to invest in longevity products. For this reason, superannuation funds must take care in understanding the different needs of retiring members and develop a range of income-based products.

A more integrated approach

As discussed above, the desire for most retirees is to have a secure and stable income for life, together with some flexibility. However, the current Australian retirement income system is not set up to provide such an outcome.

Let’s consider five possible sources of retirement income:

- The means-tested Age Pension is payable for life but the level of income will depend on the individual’s (or couple’s) income and assets, excluding the family home. Hence its amount is uncertain as movements in asset values due to the market and changes to the means tests or the deeming rate may affect it.
- Account-based pensions where, as discussed above, many retirees withdraw the minimum or near minimum amount. Naturally, these income amounts reflect the underlying asset values which could rise or fall by up to 20 per cent from year to year. For retirees receiving the full Age Pension or no Age Pension, such changes will have a direct impact on their income. The impact on those receiving a part Age Pension may be less due to the effect of the means tests.
- Longevity or pooled products, where the longevity and other risks can be shared. As with all insurance-type products, there will be some “winners” and some “losers” depending on the experience. The threat of “loss” discourages some investors. In addition, many retirees perceive the superannuation benefit as their right – after all, employers paid it as a percentage of the individual’s earnings. Therefore, they do not wish to share it or pool it with others in respect of future risks.
- Income from the home through an equity release arrangement. As noted above, this is not seen as an attractive option for many retirees at the moment. Given the value of many homes in Sydney and Melbourne, in particular, it is appropriate for this potential source of revenue to explored by the Review.
- Additional income from employment, which is more likely to occur in the earlier years of retirement.

In summary, most of the above sources of income do not provide a secure and stable income for life. Rather, they can be considered to represent pieces of a jigsaw that do not fit together easily. Hence it is no wonder that many retirees delay making decisions because it’s all too hard, seek financial advice or adopt a conservative approach towards their expenditure as they face many uncertainties relating to their own life expectancies, future income sources, as well as the unknown and unpredictable health and aged care costs in the future.

Australian retirees deserve better. In that respect, Chapter 7 will outline a radical alternative that provides greater certainty and clearer objectives for each pillar of our system.

Accumulation and decumulation are not the same

During the last 30 years the Australian superannuation system has done a very good job in accumulating significant assets for retirement. However, it has not focussed sufficiently on the development of retirement income products. As mentioned several times in this submission, it is time for the superannuation system to focus on retirement income. That will require relevant legislation as well as stronger focus on retirement incomes in all member communications.

Another area that is worth exploring is the different investment strategies that are appropriate in the accumulation and pension phases. Many superannuation funds continue to offer members the same or similar investment options in the accumulation and decumulation stages. This is not appropriate. After all, in the accumulation years the investment horizon is long term and there are no withdrawals. Short term market volatility should not be a major issue. Rather, the focus should be on generating wealth for the retirement years.

The pension years are very different. First, money is being withdrawn on a regular basis and access to readily available capital is desired by many retirees. Second, retirees have a different attitude to their many uncertainties and are concerned that their money may run out. Third, the time horizon is much shorter. The industry needs to recognise these differences and develop appropriate and relevant investment strategies for the accumulation and pension phases.

Keith Ambachtsheer, one of the world's most respected pension experts, said the following in his latest newsletter:

> "The 2 Pot Pension Model accommodates the individual life-cycle reality that young plan members worry about the cost of their eventual pension ('how much do I need to save?') while older plan members worry about payment security ('will I continue to get my pension as long as I live?'). The simplest design answer to these worries is for the plan to offer return-generation and payment safety pots. Plan members shift assets from the first pot to the second pot as they age. The 2-Pot model is easily adopted by any retirement income system with a capital accumulation/DC history (e.g. Australia)."[29]

Wise words indeed. It is time the Government and the superannuation system recognise more strongly that the accumulation and pension phases are very different and are tackling different issues.

Observation

There remains much to be developed in respect of retirement incomes within the Australian system.

We need improved tools and guidance for retirees, a broader range of products, better integration between the main sources of income and further development of investment approaches and products that are designed for the pension phase.

[29] Ambachtsheer Newsletter (2020), *Return, Risk Time Horizon and Pension Plan Design*¸ January.

6

SUGGESTED IMPROVEMENTS TO THE CURRENT SYSTEM

A. THE MEANS TESTS

The assets and income tests for the Age Pension are complicated and confusing for many retirees. They also influence their behaviour and financial decisions. In short, simplification is needed.

One option is a single income test as occurs in many other systems.

Of course, the current assets test includes some assets where there is no income and hence represents a broader test than the income test alone. However, this could be solved through the concept of deemed income that already applies to financial assets and a similar approach could be applied to all assets, excluding the family home. This would also improve equity within the system as all assets would be treated in a similar way.

The current approach with two means tests also highlights inconsistencies and inequities. For example, in 2019 the Government reduced the deeming rates used for the income test but made no change to the taper rates that apply for the assets test. Hence, the taper rates for the assets test were made relatively stronger when compared to the income test.

The inconsistencies that exists between the two tests which leads to inequities within the system can be seen in the following example.The income test taper rate of 50 per cent means that part pensioners keep half of their additional income. On the other hand, the taper rate in the assets test of $3 per fortnight for every additional $1,000 of assets is equivalent to an earning rate of 7.8 per cent. This rate is well above the investment earnings expected from almost all assets under the current economic conditions. It has been suggested that this very strong taper exists to encourage retirees to draw down their capital. However, if this is the objective, it is not present with the income test.

We therefore urge the Panel to review the purpose of the taper rates and to propose a simpler system with clear objectives recognising their effect on behaviour of retirees as well as the impact on the Government’s fiscal position.

B. FINANCIAL ADVICE

We recommend the Panel review the financial advice that can be offered by superannuation funds and make it clear that intra-fund advice can encompass a range of topics related to the products offered by the superannuation fund including insurance, investment options, transition to retirement as well as retirement.

Given the complexity of the current system, most retirees require some help in their financial planning for retirement. Superannuation funds are a natural starting point for many prospective and current retirees to obtain advice. After all, individuals already have a relationship with their superannuation fund. In fact, intra-fund advice arrangements have proven to be successful for fund members in assisting them to choose their insurance and investment strategies along with an appropriate contribution rate to achieve comfort in retirement.

However, the scope of financial advice that a superannuation fund can offer their members remains unclear given the continuum from general information through to intra-fund advice, scaled advice and holistic advice.

We therefore recommend the Panel review the scope of intra-fund advice and more specifically the need for members to receive good advice as they transition to post employment and retirement. Some topics are clear (investment, insurance and contributions) but the ability to offer appropriate transition to retirement advice remains an area that needs improvement.

Mercer also supports the ability for funds to charge members collectively for the cost of intra-fund advice, noting the importance of this service and the increasing access by members.

C. GENDER ISSUES

It is well known that the average female superannuation balance is well below the average male superannuation balance. There are several reasons for this outcome, including:

- Many females take time out of the workforce to care for children and ageing relatives
- The impact of this “time out” on future promotion opportunities
- There is a higher proportion of females in the part time or casual workforce
- There is a higher proportion of females working in industries where the average wage is lower. These include but are not restricted to the “caring” industries.
- The impact of the $450 per month threshold for SG purposes
- Lower wages for the same work in some cases

In essence, the causes of this difference are primarily societal and not directly related to the superannuation industry. However, there are measures that can be taken to improve the current gender gap. These include:

- Removing the $450 threshold as discussed in Chapter 4
- Ensuring that the SG is paid on all paid parental leave payments
- Introducing the concept of a superannuation account for a couple

The last point highlights the need to consider retirement finances from a household perspective rather than in respect of each individual. After all, 70 per cent of people retire with a partner. Hence we recommend the Panel consider permitting easier rollover of superannuation balances between members of a couple.

7

A RADICAL ALTERNATIVE FOR RETIREMENT INCOME

It is universally agreed that the interactions between the three pillars within the Australian retirement income system are complex. Furthermore, these complexities can lead to considerable inefficiencies, additional costs, as well as perverse incentives and poor understanding for many individuals and households. In short, it produces additional stress and uncertainties for many retirees as well as providing sub-optimal outcomes. Change is needed.

The primary complexity is the application of the means tests to the assets held and the income received by those above the Age Pension eligibility age. The means tests were originally introduced to ensure that the Age Pension was only received by those who desperately needed it. That is, it was to be focused on the alleviation of poverty.

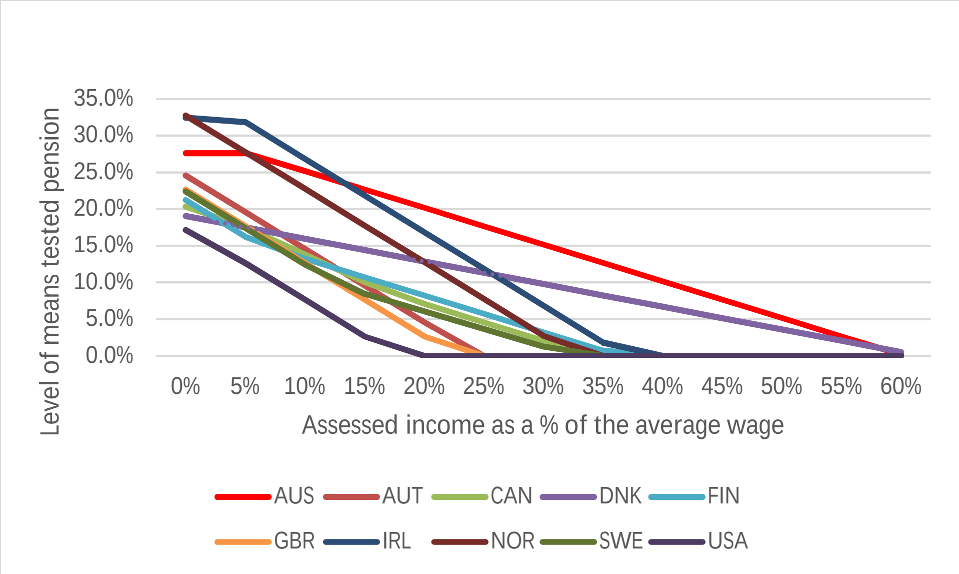
However, as discussed Chapter 2, a part or full Age Pension is now received by about two-thirds of those above the eligibility age. It is no longer received just by those who are facing the presence or threat of poverty.

Internationally, the Australian Age Pension is different from most other means-tested pensions in other OECD countries in three ways:

1. It is a higher amount, when expressed as a percentage of the average wage
2. The income test taper is at 50 per cent and not 80 or 100 per cent
3. There is an income threshold before the taper rate applies

The effect of each of these features means that a much higher proportion of the aged population in Australia receive a part or full Age Pension than occurs in most OECD countries. Figure 7.1, taken from the data in Knox (2018), shows the effects of different taper rates and the presence (or absence) of a threshold for income tested pensions. It is also worth noting that this graph only represents about half of Denmark's pension; the balance is universal (or not means-tested). It is clear that the Australian means-tested pension is unusual, primarily for the reasons outlined above.

Figure 7.1: The impact of income testing in Australia and nine other OECD countries



To reduce the complexity and improve the efficiency of the overall system, let's explore the concept of a universal Age Pension, that is, one with no means tests. Such pensions occur in Canada, Japan, the Netherlands, New Zealand and the United Kingdom. In brief, all individuals above the required age in these countries and who satisfy the residential requirements receive the pension. Simple.

Observation

A universal Age Pension would considerably simplify the Australian retirement income system.

Of course, a major concern with such an arrangement would be the significant extra cost to the Commonwealth budget. In that context, the following four factors need to be considered.

First, the introduction of a universal Age Pension would reduce the relative importance of superannuation for many retirees. That is, superannuation would supplement the Age Pension for all retirees. As a consequence, the SG contribution rate required to provide the same living standard in retirement for median and average income earners could be lower than under the current legislation. Naturally this would reduce the cost of the projected superannuation taxation concessions as well as increasing the level of take-home pay for many employees, thereby increasing taxation revenue. Second, the Age Pension should be taxable for all who receive it. However, many retirees currently pay no income tax due to the presence of SAPTO and the tax-exempt status of income received from account-based pensions. Hence, an alternative mechanism to tax future Age Pension payments needs to be found.

One option would be to base the tax rate applied to the Age Pension on the balance in the individual's tax-exempt pension accounts, noting that these are limited to $1.6 million at retirement. As an illustration, the full Age Pension could be "taxed" at 10 per cent for balances between $400,000 and $800,000 rising to 40 per cent for higher balances. This approach could also be considered fair as the superannuation balances would have received some form of taxation support. The actual thresholds could be determined after some modelling which could also allow for the likely investment behaviour by retirees.

Third, the taxation arrangements for superannuation could be modified given that every aged Australian would be receiving an Age Pension. It is also noted that most retirees appreciate the Age Pension, as it represents a direct payment, much more than the superannuation tax concessions as the benefits from these concessions are often unseen and therefore underappreciated.

Some examples of adjusting the superannuation taxation arrangements to help offset the additional costs could include:

- Requiring all superannuation balances above $5 million to be removed from the superannuation system at a particular age, say age 75.
- Introducing a limited tax on the investment income of pension accounts. Whilst it could be argued that this may encourage some retirees to remove their pension accounts from superannuation, a tax rate of say 5 per cent is unlikely to generate such behaviour, given the broad range of investments held by superannuation funds and the likely higher return than from readily accessible investments such as term deposits.
- Removing the indexation of the Transfer Balance Cap for the next 10 years, as the individuals affected would now be receiving a taxed Age Pension.

Fourth, it is noted that the projected cost of public pensions in Australian will be one of the lowest of any OECD country by 2050[30]. This does not suggest that we should spend extravagantly on the aged population. Rather, it recognises there may be some fiscal headroom to increase our expenditure on the aged population.

Table 7.1 compares the net replacement rates for a range of income levels under this alternative with those under the current arrangements. Although different modelling assumptions may yield slightly different results, the important conclusion is that the net replacement rates under this simpler system could be very similar to those achieved under the existing complex system.

Table 7.1: Net replacement rates under the current arrangements and the alternative system[31]

Income level as a % of Full Time median	75%	100%	125%	150%	200%
Current arrangements with SG rising to 12%	83.7%	71.3%	62.4%	57.7%	53.7%
Alternative system with SG at 10%	84.2%	75.7%	63.6%	56.2%	50.1%
Assumed tax rate on Age Pension	0%	0%	10%	20%	30%

[30] OECD (2019), Table 8.5 suggests a projected cost of 3.7% of GDP compared to the OECD average of 8.3%.

[31] For the purposes of this comparative exercise, we have assumed the individual commences work at age 25 and retires at the pension eligibility age of 67. The retiree receives a level income throughout retirement to age 96, indexed to wages. This income is comprised of the available Age Pension and a withdrawal from an account-based pension to maintain their real income. The economic assumptions used are net investment earnings of 6.5% before retirement and 6.0% after retirement. Wages are assumed to increase at 3.5% pa.

Whilst the potential for an additional cost is recognised, the introduction of a universal Age Pension would have considerable benefits for the economy, the financial advice industry, the superannuation industry and most importantly individuals and households. Some of these benefits include:

- The incentive to save for retirement would be much clearer. Whilst the Age Pension would be taxable, it would be clear that there would be an additional future benefit to the individual for every extra dollar contributed into superannuation. This is not the case today.
- Median to average income earners would no longer be affected by the means tests in the early years of their retirement.
- Financial decisions by retirees would no longer be made to maximise the Age Pension according to the means test rules.
- The need for financial advice should be reduced. As noted in Chapter 5, most retirees require some form of financial advice. Yet, as the baby boomers continue to retire, the number of financial advisers is reducing due to the introduction of the FASEA requirements, as well as the fallout from the Royal Commission. The presence of a universal Age Pension would considerably simplify the financial affairs of retirees. In turn, this may make it easier to meet the needs of retirees through general guidance, information and education rather than advice.
- The knowledge that the Age Pension would always be available would provide greater security to all retirees. Hence, it is feasible that they may become less risk averse knowing there is some clear longevity protection provided by the Government.
- The objectives of the Age Pension and superannuation would become much clearer. The Age Pension would provide a basic income for all older Australians whereas the objective of superannuation would be to provide additional income to broadly enable their previous living standards to be maintained through a combination of compulsory and voluntary contributions, with the actual combination depending on income levels.
- It should also provide stronger incentives to downsize the family home. Whilst the current rules permit extra contributions to be made into superannuation from downsizing, these increased assets immediately affect the level of Age Pension received.
- A much more efficient system with a reduction in Government costs from administering the current means-tested pension as well as a reduction in costs from retirees' perspectives in obtaining financial advice.
- An increase in the well-being of many retirees as the need to report to Centrelink would be removed, as well as the fear of being "caught" due to misreporting. Although difficult to measure, this freedom should improve their mental health.

The introduction of a universal Age Pension would also mean that the SG rate need not increase to 12 per cent, as currently legislated. This development could also give the opportunity for the additional contributions (say 2 per cent over time) to be directed towards aged care funding.

The current Royal Commission into Aged Care in Australia is almost certainly going to highlight the need for additional funding for aged care. Inevitably this will be an extra cost to the Commonwealth budget and this cost is likely to increase at a much faster rate than GDP growth in future years. Hence additional sources of funding will be required.

One option would be to limit the SG rate to 10 per cent together with the introduction of the universal Age Pension and to gradually introduce an aged care funding levy. Unlike superannuation, these funds would not be allocated to an individual account. Rather, they would be pooled and enable additional funding to be provided to the aged care industry and thereby improve the living standards of many older Australians. Such an outcome is very consistent with the purposes of superannuation. The broader provision of quality aged care is likely to lead to less conservative spending behaviour by retirees in the earlier years of retirement which would improve their quality of life as well as providing a boost to the economy.

Observation

The introduction of a universal Age Pension may not be considered a viable political option in the current environment.

However, when packaged with an unchanged SG rate, a simpler system, some taxation adjustments to superannuation and additional funding for aged care, the package may prove compelling.

APPENDIX A

A LINK TO THE CONSULTATION PAPER QUESTIONS

Topic	Questions	Relevant section in this submission
The retirement income system	1	2A
Purpose of the system and the role of the pillars	2-6	2A, 2B
The changing Australian landscape	7	3, 5, 6
Principles for assessing the system	8-9	1
Adequacy	10-12	2B, 2C, 3A, 4, 5
Equity	13-17	4,7
Sustainability	18-20	3B,7
Cohesion	21-26	2B,7

APPENDIX B

REFERENCES

Actuaries Institute (2019), *Options for an Improved and Integrated System of Retirement*, Sydney.

Altmeyer, Arthur J (1945), Goals for Social Security, A radio address, February 11.

Ambachtsheer Newsletter (2020), *Return, Risk Time Horizon and Pension Plan Design*¸ January

Australian Bureau of Statistics (2019), Labour Force, Australia, May

Australian Bureau of Statistics (2019), Household Income and Wealth, Australia, 2017-18

Financial System Inquiry (2014), *Final Report*, Australian Government, Canberra.

Grattan Institute (2019), *Money in Retirement: More than enough,* April.

International Labour Organization (2019), www.ilo.org.

Knox D M (2018), *Retirement incomes: Australia v the Rest of the World*, Actuaries Institute, Financial Services Forum.

McKell Institute (2019), *Opportunities in Change: Responding to the Future of Work*.

Mercer (2019), *Great Expectations – Attitudes and Behaviours amongst Australian Retirees* https://www.mercer.com.au/our-thinking/superannuation/great-expectations-attitudes-and-behaviours-amongst-australian-retirees.html

Mercer (2019), *Melbourne Mercer Global Pension Index*, Monash Centre for Financial Studies, Melbourne.

OECD (2019) *Pensions at a Glance OECD and G20 Indicators*, OECD Publishing, Paris.

Productivity Commission (2018), *Superannuation: Assessing Efficiency and Competitiveness,* Overview

Thurley, Djuna (2019), *Pensions: automatic enrolment – current issues*, Briefing Paper, February.

Tinbergen J (1952), *On the theory of economic policy,* Amsterdam: North Holland.

World Bank (1994), *Averting the Old Age Crisis*, Oxford University Press

MERCER CONSULTING (AUSTRALIA) PTY LTD
ABN 55 153 168 140
AFS Licence # 411770
Collins Square
727 Collins Street Melbourne VIC 3008
GPO Box 9946 Melbourne VIC 3001
www.mercer.com.au

MARSH & McLENNAN
COMPANIES