MONASH University

MONASH BUSINESS SCHOOL

Retirement Income Review Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

3 February 2020

Subject: Retirement Income Review (RIR)

Dear RIR Panelists,

Monash Centre for Financial Studies (MCFS) appreciates the Treasury's invitation to make a submission responding to the Retirement Income Review consultation paper released on 22 November 2019.

MCFS is a research centre at Monash University within the Monash Business School. The purpose of the centre is to provide a platform for researchers in academia and practice by focusing on industry-relevant research and thus bridging the current gap between the two. MCFS aims to foster the twin goals of advancing academic scholarship and actively engage with '*research end-users outside of academia, for the mutually beneficial transfer of knowledge, technologies, methods or resources*' (ARC, 2017).

MCFS has a keen research interest in the retirement income system as we consider the area to be of national significance and in the best public interest. We recognise that to understand how the retirement income system operates and what it will be able to deliver in the future, a holistic approach is needed. We, therefore, have identified the following topics which we would like to assist the Panel in establishing the fact base of the current system.

Our comments concerning each topic, are in the attachment to this letter, as follows:

1. Design of retirement income systems: response to Question 1 of the Consultation Paper.
2. The changing Australian landscape: response to Question 7 of the Consultation Paper.
3. Principles for assessing the system: response to Question 9 of the Consultation Paper.
4. Adequacy/Equity/Sustainability/Cohesion: response to Questions 11 and 14 of the Consultation Paper.

Should you need further information on the above topics or other related matters, please do not hesitate to contact us at mcfsinfo@monash.edu or 03 9903 8318. We would be delighted to discuss additional insights informed by our research with you.

Yours sincerely,

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ATTACHMENT

The retirement income system

CQ1 – Are there aspects of the design of retirement income systems in other countries that are relevant to Australia?

The Australian retirement system, which has been ranked world-class[1], is not perfect in its current design. In our view, there are two main issues with the way the current system is designed, namely: the economic distortion created by the age pension; and the marginalisation of gig economy workers.

Australia is the only country with its age pension based on both an assets test and an income test[2]. This means that the more assets and income people have, the less likely they are to access age pension entitlements in retirement. Additionally, the fact that the value of the family home is not included in the asset test creates an incentive for retirees to hold on to a large house and live frugally on a very modest income, trying to stay eligible for the age pension. Other benefits attached to the pensioner concession card, including cheaper health care, medicines and other discounts creates further distortion to the economic behaviour of retirees to maintain their eligibility for the age pension.

The means-tested age pension also creates disincentives for some individuals to save more for retirement (we elaborate on this point later in CQ14).

For the above reasons, we would recommend making the age pension universal, as is the case for some of the other highly ranked pension systems in the world.

As detailed in Table 1, the Netherlands and Denmark, both of which ranked higher than Australia in the MMGPI Index in 2019, have a universal pension. The only difference between these two top-ranked pension systems is that Denmark's system also provides a means-tested income supplement component[3].

Based on this, we recommend Australia to adopt a system with a universal age pension. As the current means-tested age pension created some anomalies and disincentives, we would recommend further investigation into it, before supplementing the universal age pension with other means-tested income components, similar to that of Denmark. An additional effect of a universal age pension would be a considerable reduction in administrative costs.

We understand that making the age pension universal would create an additional burden to the government budget. One example of funding this could be the National Insurance (NI) scheme in the UK.

Another way is to finance it is through the existing superannuation system. Along with widespread occupational defined contribution (DC) schemes, the government can introduce statutory defined benefit (DB) schemes to fund a lifetime indexed annuity for retirees, similar to Singapore's system. The government can channel some (or all) of the compulsory superannuation contributions to fund these annuities along with individuals contributing to their retirement (Cohen & Ruthbah, 2019)

Additionally, the current system has not responded well to the changing nature of employment. In today's economy, temporary and flexible jobs are becoming the norm with independent contractors

[1] Mercer (2019), *Melbourne Mercer Global Pension Index*, Monash Centre for Financial Studies, Melbourne.
[2] David Knox (2018), Retirement incomes: Australia v the Rest of the World, accessed at https://www.actuaries.asn.au/Library/Events/FSF/2018/DavidKnoxPaper.pdf on 23 Jan 2020.
[3] The pension supplement is reduced when the earned income other than the social pensions exceeds a given threshold. Apart from that, in Denmark, there is also a taxable annual supplementary pension benefit for poor public old age pensioners, which is means-tested and conditioned on a maximum threshold of liquid asset value. Source: OECD (2017) Pension at a Glance 2017: Country Profiles - Denmark

representing about 8.2 per cent of total employed persons in 2017[4]. These "gig-economy" workers have less protection and benefits than their permanent counterparts. Their temporary and/or independent contract employee classification status also has implications for superannuation.

Current superannuation guarantee (SG) regulations require an employer to pay a SG on top of the wages to employees receiving at least $450 (before tax) per calendar month. Even though this seems to be a low threshold for an employer, it may not be so for a worker working casually for multiple employers at the same time. If the wage from each employer was below the threshold, the employee would not receive any superannuation. Compares to another worker who receives the same total monthly salary from a single employer, this 'gig' worker would receive SG payments on their total salary. We recommend removing the $450 SG threshold, which would increase the coverage of superannuation to include gig-economy workers. We understand that this may introduce inefficiencies in that many small SG contributions would arise. However, this issue has already been a focus on the Banking Royal Commission. In its final report[5], recommendations around setting up one account together with low-cost MySuper offerings should address this.

Table 1: Age Pension and other features[6] of selected pension systems around the world

Pension system	MMGPI 2019 grade	Pillar 1		Pillar 2	Pillar 3
		Universal age pension	Income supplement	Compulsory superannuation	Voluntary savings
The Netherlands	A	Yes	No	Earnings-related occupational pension	
Denmark	A	Yes	means-tested pension supplementary benefit	A fully funded defined contribution scheme; Mandatory occupational schemes	
Australia	B+	Means-tested age pension (based on both assets and income)		Employer contribution	Voluntary contributions from employers, employees and self-employed
Canada	B	Yes	Means-tested	Earnings-related pension based on revalued lifetime earnings	Voluntary occupational schemes and individual retirement savings plans
Finland	B	Income-tested basic national and guarantee pension		Statutory earnings-related schemes	Voluntary occupational and personal pensions
Germany	B	Means-tested safety net		Earnings-related pay-as-you-go pension	Supplementary occupational pension plans
New Zealand	B	Yes	No		Voluntary private pensions KiwiSaver direct contribution retirement savings schemes
Italy	C	Minimum means-tested social assistance benefit		Notional defined contribution scheme	Voluntary supplementary occupational schemes (low coverage)
United Kingdom	C	Yes	Income-tested pension credit		Voluntary occupational and personal pensions
United States	C	Yes	Means-tested supplemental security income	Progressive social security benefits	Voluntary occupational and personal pensions

[4] Victorian Parliament Library and Information Service (2018), *Labour Rights in the Gig Economy – an Explainer*, Research Note, No. 7, Victoria.

[5] https://www.royalcommission.gov.au/sites/default/files/2019-02/fsrc-volume-1-final-report.pdf

[6] The pillars in the following table refer to the Three Pillars discussed on page 4 of the Consultation paper.

The changing Australian landscape

CQ7 – Demographic, labour market, and home-ownership trends affect the operation of the retirement income system now and into the future. What are the main impacts of these trends? To what extent is the system responsive to these trends? Are there additional trends which the Review should consider when assessing how the system is performing and will perform in the future?

Apart from superannuation, household savings, household debt and home ownership are the other factors that can affect retirement income, as identified under Pillar 3 of Australia's retirement income system in the Consultation paper. Figure 1 depicts how the Australian landscape can be compared to other markets.

Net household saving rate (%) is defined as the difference between personal disposable income and private consumption as a percentage of personal disposable income.

Net household debt to GDP ratio (%) is the total household debt expressed as a percentage of GPD.

Homeownership (%) rate is defined as the number of owner-occupied housing units by the total number of occupied housing units.

For further explanation, please refer to MMGPI 2019 Report.

Figure 1: Net household saving, household debt and homeownership in 2019
Data source: MMGPI 2019

Based on the dataset used for the Melbourne Mercer Global Pension Index 2019, we can observe that while the net household saving rate is quite low for Australia compared to other pension systems in the MMGPI, our household debt is significantly higher than the MMGPI average, at 124.5% of GDP. A low saving rate, coupled with high household debt, may have important implications for future household wealth and retirement adequacy. Household debt creates financial liabilities to be paid in the future. Given the ability for retirees to take the accumulated pension as a lump sum, may enable them to use the accumulated pension to pay off mortgages and other debt once they have access to their superannuation savings. However, if the households have adequate assets to back up these debts, then the magnitude of this debt might not be as alarming as what is suggested by the MMGPI, especially under the current market scenarios, where interest rates and inflation are very low.

Therefore, further research is warranted to predict if the current landscape of relatively low saving and high debt would have an adverse effect on retirement adequacy of Australians in the future.

Principles for assessing the system

CQ9 – How does the system balance each of the principles and the trade-offs between principles (e.g. sustainability and adequacy) under current settings? What is the evidence to support whether the current balance is appropriate?

One example for assessing pension systems is the annual Melbourne Mercer Global Pension Index (MMGPI). The MMGPI assesses and ranks pension systems around the world in terms of adequacy, sustainability and integrity[7]. Figure 2 reveals the position of the MMGPI pension systems on a four-dimension assessment of MMGPI pension systems in terms of the three assessment criteria and their size, measured by pension assets expressed as a percentage of GDP. From this cross-sectional distribution of the pension systems, there seems to be no clear trade-off between adequacy and sustainability. It also shows that most large pension systems tend to perform well in terms of both adequacy and sustainability. Please refer to MMGPI 2019 report for the detailed discussions of each assessment criteria.

The median scores of adequacy and sustainability of MMGPI systems divide the space into four quadrants, with Quadrant 1 in the top right corner.

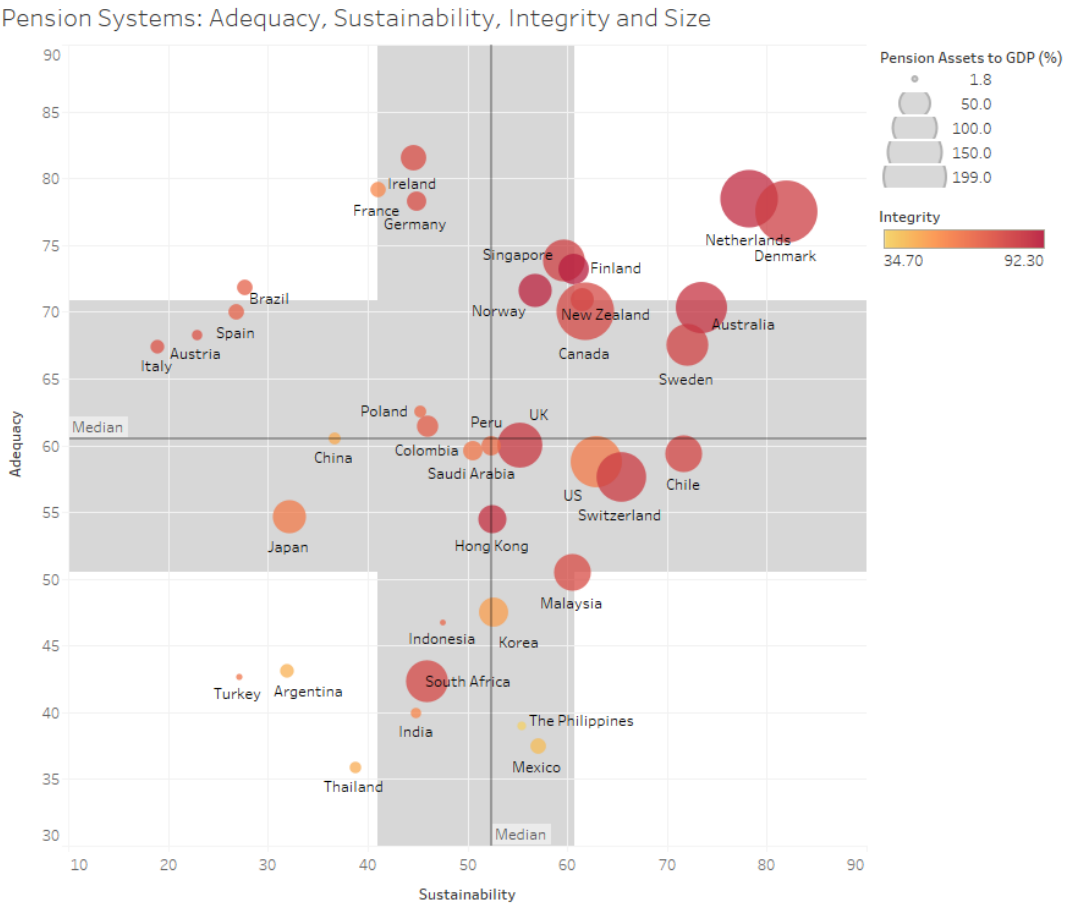


Figure 2: Adequacy, Sustainability, Integrity and Size of MMGPI Pension Systems – 2019

Ranked behind the Netherlands and Denmark in 2019, Australia belongs to Quadrant 1, with both *Adequacy* and *Sustainability* sub-scores higher than the MMGPI-median. Most pension systems in

[7]Pham, N. (2019), Overview of the Australian Superannuation System, Monash Centre for Financial Studies, Melbourne.

Quadrant 1, including Australia, are relatively large in size, as indicated by the size of the dots, and have high integrity scores, reflected by the shades of red.

A number of other large pension markets, such as Switzerland, the US and UK, belong to Quadrant 2 due to their lower *Adequacy* sub-score.

Adequacy

CQ11 – What evidence is available to assess whether retirees have an adequate level of income?

In order to assess whether retirees have an adequate level of income, it is first important to identify that level. According to ASFA (2019), a single male retiree would require to spend $43,787 a year to lead a comfortable retired life and $27,913[8] for a modest lifestyle. The Grattan Institute study (Daley et al., 2018) claims that the ASFA standard is "unrealistic" and offers a 'lifestyle more luxurious' than most Australians have during their working age.

The Moneysmart calculator from ASIC[9] shows that a retiree with a $570,000 superannuation balance can spend $40,250 until the age of 90 and then depend entirely on the age pension ($24,268 p.a. in today's dollars). ASFA has a similar perspective on this as the ASIC. According to their Super Guru website, a male retiree with a life expectancy of 86 years can live a comfortable retired life[10] with a superannuation balance of $545,000[11].

However, our simulation model[12] shows that a $570,000 portfolio with a 60/40 equity/bond allocation has a 30% chance of running out at year 30 into retirement and a 15% chance that the retiree will fall back fully on the age pension 25 years into retirement (Panel A, Figure 3). The point is, even a $570,000 super balance may not be enough to guarantee a comfortable retired life for all life expectancies. Figure 3 shows the probability that a 60/40 portfolio will run out of money at any given year of the retiree's life for different superannuation (SA) balances. We find that retirees who are not eligible for the age pension (with a SA balance of $600,000) at the beginning of their retirement life (as their asset level is above the maximum threshold of $574,500) also has a 13% chance of falling back solely on the age pension 25 years into retirement.

However, most retirees in Australia have a SA balance far less than the ASIC recommended $545,000. The average SA balance of a retiree aged 64-75 in 2017-18 was $402,600, and the median was $225,200[13]. As Figure 3 shows, a retiree with a $400,000 SA balance has a 20% chance of drawing down their assets to zero 20 years into retirement. This goes up to more than 50% as they turn 95. The picture is grimmer for the majority of Australian retirees whose SA balance is just below the pension tapering threshold. A portfolio of $260,000 will run out of money at the end of 15 years with a probability of 33%. These are substantial risks which retirees should be aware of before deciding on their spending trajectory. The above observations also have consequences for the fiscal budget. If retirees become eligible for age pension before they are expected to and hence receive the age pension for longer periods than the government has anticipated, this would generate unanticipated stress on fiscal balances.

[8] https://www.superannuation.asn.au/resources/retirement-standard

[9] https://www.moneysmart.gov.au/tools-and-resources/calculators-and-apps/super-and-retirement-calculators

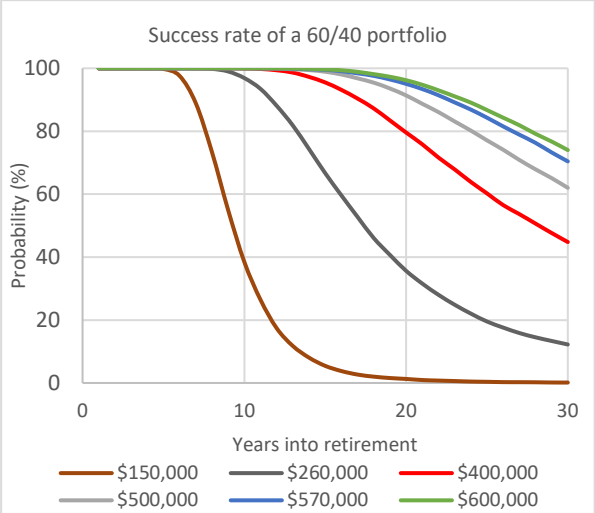
[10] They assume a basic age pension (before payment of supplements) of $21222 a year and an inflation adjusted annual spending of $43601.

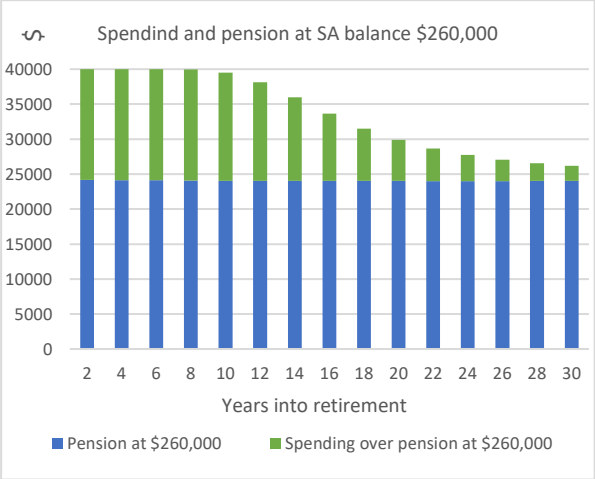
[11] http://www.superguru.com.au/retiring/how-much-super-will-i-need

[12] For details of the assumptions made in our simulation, please refer to Ruthbah (2020).

[13] ABS statistics, 2019.

Figure 3





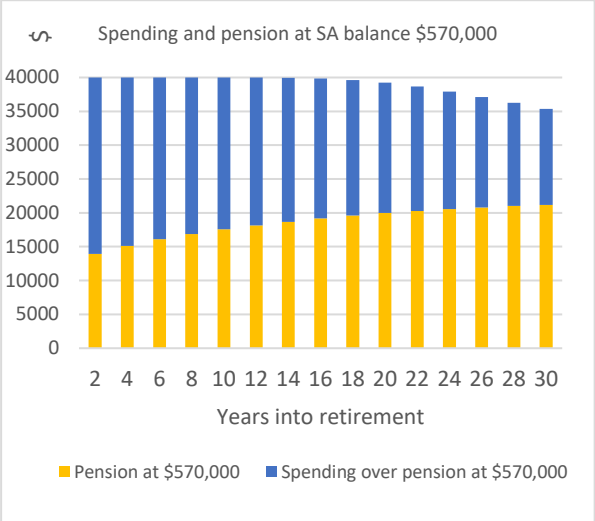
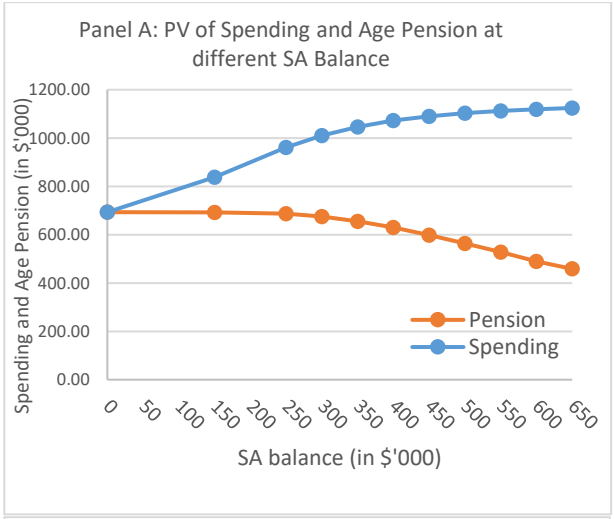
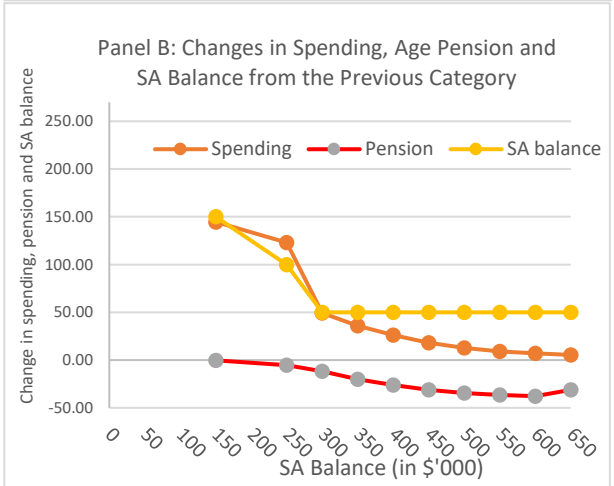
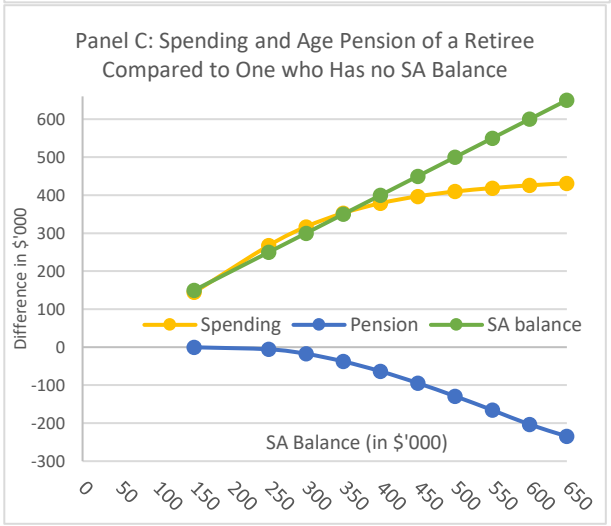


Figure 4:







Equity

CQ14 – What factors and information should the Panel consider when examining whether the retirement income system is delivering fair outcomes in retirement? What evidence is available to assess whether the current settings of the retirement income system support fair outcomes in retirement for individuals with different characteristics and/or in different circumstances (e.g. women, renters, etc.)?

The current means-tested age pension creates an anomaly in the relationship between the level of assets a retiree has and their expected spending in retirement. We find that a higher SA balance at the beginning of retirement results in higher spending during retired life but not necessarily at the same proportion (Ruthbah, 2020). A specific increase in SA balance does not translate into an increase in the present value of spending by the same amount. We also find that the relationship between the change in SA balance and the change in the present value of the age pension a retiree is eligible to receive is not linear and is regressive for a range of asset levels.

The present values[14] of retirement spending and the age pension a retiree is entitled to at different asset levels (as predicted by our simulation) are presented in Panel A of Figure 4[15].

Panel B shows that as SA balances increase from 0 to $150,000, the present value of spending increases by $144,620, as the retiree is eligible for less pension. At higher asset levels, for example at $400,000, as the asset level increases by $50,000 to $450,000, the present value of spending increases by only $25,990 as the retiree receives $26,000 less in age pension. Overall, the relationship between the pension and spending with SA balance is non-linear. This becomes even clearer if we examine Panel C of Figure 4. It shows that as SA balances increase from zero, retirees at some asset level (between $160,000 and $350,000 approximately) can spend more than the increase in their SA balance. This provides incentives to those just above this asset level to invest a part of their SA balance into something that does not count toward the asset test (for example, renovate the family home and increase its value) and enjoy a higher age pension, or consume to enjoy this same benefit. The present value of the age pension does not decrease at the same pace as a retiree's SA balance increases, making the system regressive.

The fact that the sacrifice of current consumption to improve SA balances does not lead to an equivalent increase in future spending power may also provide retirees at some asset ranges a disincentive to save more for retirement or to spend their assets/savings on unproductive or unnecessary consumption (in the sense that they would not have spent that amount in the absence of the pension tapering mechanism). This enables them to remain eligible for a full or part pension (Bütler, Peijnenburg, & Staubli, 2017; Andreasson, Shevchenko, & Novikov, 2017). This again puts further pressure on fiscal balances.

A potential solution to this inequality and misaligned incentives for retirement savings could be the introduction of a universal age pension. Detail of this proposal is in Cohen & Ruthbah (2019) so will not be discussed further here.

References:

Andreasson, J., Shevchenko, P., & Novikov, A. (2017). Optimal consumption, investment and housing with means-tested public pension in retirement. *Insurance: Math. Econ*, 32-47.

Bütler, M., Peijnenburg, K., & Staubli, S. (2017). How much do means-tested benefits reduce the demand for annuities? *J. Pension Econ. Finance*, 419-449.

[14] The present values are estimated for a discount rate of 0.321% which was the 30 year bond rate when we ran the simulation.

[15] We confine our analysis to this range of superannuation balance as above $800,000, the retiree needs to withdraw more than $40,000 during the initial years of retirement to maintain the minimum withdrawal rate of 5%. Besides, retirees who have a larger superannuation balance are less constrained by market returns, risk of longevity or sequencing.

Cohen, R., & Ruthbah, U. (2019), *Pitfalls in the Retirement System and Some Thoughts about Risk, Reward and Remediation.* Melbourne: Monash Centre for Financial Studies. White Paper 01-19.

Daley, J., Coates, B., Willshire, T., Emsile, O., Nolan, J., & Chen, T. (2018), *Money in retirement: More than enough.* Melbourne: Grattan Institue.

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