Retirement Income Review

Submission of Rob Paton : 28 January 2020

Background : Rob Paton

Rob Paton worked as an independent consulting actuary, providing financial-related advice to superannuation entities for 25 years. In the early 1990s, Rob was the Convenor of the Committee which represented the Actuaries Institute in discussions with regulators, public servants and politicians during the introduction of the Superannuation Guarantee legislation and the Superannuation Industry Supervision legislation. During the early 2000s, Rob was a member and Convenor of the ASFA Best Practice Superannuation Committee, which was responsible for rewriting ASFA's Best Practice Superannuation Standards. Rob is retired now.

Submission

Thank you for holding this review of Australia's Retirement Income System, and for providing the opportunity for a written submission to be made by a member of the public.

This submission addresses the two major groups of Questions from the Consultation Paper, namely the Purpose of the Retirement Income system, and the Principles for Assessing the System.

Unfortunately, the Superannuation Guarantee (Super Guarantee) was introduced without a written associated purpose statement, which continues to be the case today. Verbal discussions at that time as to purpose were to broaden the superannuation savings net to the non-unionised employed (because voluntary employer-provided superannuation was being wound back at that time), and to increase saving (and therefore formation of long-term capital) in the Australian economy, because the rate of saving among the Australian public was low at that time.

While concerns were raised with the Actuaries Institute by the Senate Committee which considered the Super Guarantee legislation as to whether a mature Super Guarantee would overwhelm the available Australian investments market, no consideration was made public to my knowledge as to the anticipated wider economic effects of establishing such a substantial savings pool.

The Super Guarantee needs to be considered and assessed **first** from the perspective of the costs for Australians living in retirement and who did not have substantial pre-retirement incomes or post-retirement assets, and **second** from the effect that the Super Guarantee has on the Australian economy as a whole. As stated in the Terms of Reference, a Fact Base needs to be established around these two criteria.

1. Purpose of the System and Role of Pillars

From a retirement costs perspective, for retired Australians without substantial post-retirement assets, currently there are two essential Pillars to preparing to be able to pay for retirement costs, first unencumbered home ownership at the point of retirement, and second the Age Pension and its associated benefits and discounts (which are important financially and overlooked often). Shelter is one of the four basic human needs without which independent living is not possible. The Age Pension at the current level delivers sufficient income to enable a retired person to pay for the costs of water, food and clothing (providing the person is an unencumbered home-owner), the other three basic human needs (in addition to the need for shelter). The Super Guarantee has added a third Pillar for a person who has been employed or self-employed in paid work prior to retirement.

For reasons related to the sustainability of the Federal budget, **this retirement income review should develop a fact base focussed on Australians without substantial means, using the three Pillars structure set out above.**

Rates of home ownership have been declining over recent years, and for those who do purchase their home, mortgage amounts and repayments have been increasing relative to incomes. Age Pension amounts and means testing favour home owners relative to renters, especially in the major cities. **A Fact Base needs to be established around home ownership and the extent of the increase which is required to the Age Pension to provide a retired person without substantial assets and who is not a home owner with an equivalent standard of living to a person who is an unencumbered home owner** (because rents vary materially between different Australian locations, the increase to the Age Pension can be expected to vary materially between different locations).

Long established Australian public policy and Australian social history generally mean that it is appropriate for unencumbered home ownership to be included as the first pillar for Australian retirement security. Unlike many overseas countries, Australia does not have either established legal structures to ensure long-term protection of residential tenants, or widespread provision by governments of long-term housing to lower income earners. Australians purchase residential real estate outright (as opposed to longer-term leases which apply overseas). As a result of Australia's residential real estate culture, tax and regulatory laws have been introduced which favour ownership of residential real estate over long-term renting.

Regarding **Pillar 1 (home ownership),** as an initial step, public policy could be developed with the objective of enabling an employed or self-employed Australian person within the low to middle income range to be able to afford to borrow to purchase their own (basic) home in a location which permits reasonable access to paid employment, and to pay off that mortgage over their working lifetime. Unencumbered home ownership is consistent with the Government's Ageing In Place policy for the delivery of aged care services.

Pillar 2 (Age Pension and associated discounts and benefits) is in place already, and provides sufficient income to enable basic costs to be met for a retired person, after allowing for the associated benefits and discounts which are provided to Age Pension recipients. The Age Pension is indexed each 6 months by the larger of the increase in the CPI, and the Pensioner Living Cost Index, with the resulting amount then compared to a benchmark % of Average Earnings (and further increased if the Age Pension is less than that amount). While it is not a major issue at present due to low rates of wage inflation, it would be more sustainable from a Federal Budget viewpoint for the Age Pension to increase regularly in line with the Pensioner Living Cost Index only, with benchmarking to Average Earnings occurring periodically as Budget circumstances permit.

With Pillar 1 (unencumbered home ownership) and Pillar 2 (Age Pension and associated benefits and discounts) in place, consideration can be given to developing a purpose statement for the Super Guarantee. Spending patterns in retirement for Australians without substantial means show substantial reductions after age 80, because spending capacity is aligned closely to health status which on average declines materially after age 80, especially for those without substantial means. Consumption of Health Care services increasingly characterises the years for persons after age 80 on average, with the costs associated with these services met entirely by Medicare (or by Private Hospital Insurance) for persons who have a Pensioner Health Benefits Card. Consumption of Aged

Care services increases rapidly after age 85, first by the provision of Government financed services at the person's home (Ageing in Place), moving progressively to Residential Aged Care under which the cost of the Care Services is financed by the person's Age Pension, and the cost of the Accommodation Services is met by a Government guaranteed Residential Accommodation Deposit financed by the sale of the person's residence. Traditional retirement income assessments make no allowance for the substantial reduction in spending patterns which occurs after age 80 on average, and which does need to be considered in any consideration of the quantum of the Super Guarantee contributions.

A fact base needs to be developed to document the reduction in retirement costs as a person moves through their retirement years, including whether it is reasonable to conclude that Australians in receipt of a full Aged Pension from Age Pension Age and who spend on the normal costs of living in accordance with an appropriate spending pattern can be expected on average to pass on substantial amounts from their Super Guarantee assets to their beneficiaries. The fact base would include the applicable discounts and benefits available to full Age Pensioners and to a person who is Ageing-In-Place, and could be used to develop a retirement basic needs calculator for an unencumbered home owner.

Pillar 1 and Pillar 2 above make no allowance for capital-related costs in retirement. Also, the current Age Pension ($24,000pa for a single person) does not meet costs associated with any more than basic living costs. In a working environment characterised by shortages of employment for lower skilled/lower paid occupations, it is important that lower income Australians feel able to retire from employment to open up employment opportunities for younger Australians. These issues are addressed by the additional savings available through the Super Guarantee.

Supplementation of the Age Pension by say 50% ($12,000pa currently) would require draw down from a Super Guarantee lump sum of $12,000pa over say 15 years, equivalent to a $180,000 Super Guarantee lump sum at Age Pension Age and sufficient to last into a person's 80s when spending patterns on average reduce substantially. Additional assets at retirement can be used as a capital sum to ensure any remaining mortgage is paid off, and then that capital-related basics are in place (home appliances are not too old, the home itself is well maintained, and the car is relatively new). Perhaps $100,000 could be allocated for capital-related purposes, bringing the total amount of the Super Guarantee which needs to be accumulated at Age Pension Age to a lump sum of say $280,000, equivalent to about 3.3 years of gross Full-time Adult Average Ordinary Time Earnings (about $85,000pa currently), and approximately equal to the Assets Test Limit for a single person currently, meaning that the person's Age Pension would not be expected to be reduced under means testing.

The key metrics above (the 50% increase in income and the $100,000 allocated for capital related spending) need to be validated by the Fact Base which is developed covering spending in retirement.

There should be no requirement to draw-down Super Guarantee assets as a regular lifetime income, because such a requirement would defeat the purpose of meeting capital related costs throughout retirement, and would disadvantage those with lower incomes who experience higher post-retirement mortality than those on higher incomes.

The Three Pillar system outlined above is adequate, equitable and cohesive for Australians without substantial means, whose needs are those that must take priority when determining Federal Budget priorities.

A suitable purpose statement for Pillar 3 (the Super Guarantee contribution to superannuation) therefore is:-

"**the regular employer-paid contribution (expressed as a percentage of income) over an expected average working life in respect of a person receiving an average income which is expected to accumulate (net of tax and administration expenses) to a superannuation lump sum at Age Pension Age equal to approximately X.X years Full-time Adult Average Ordinary Time Earnings (gross of tax) over an expected working lifetime."** X.X would be determined based on the spending in retirement Fact Base.

While a vast range of assumptions is available potentially to determine such an amount, the author proposes that an employer-paid contribution of about 10% of gross ordinary time earnings would be determined currently, with gross ordinary time earnings capped at Full-time Adult Average Ordinary Time Earnings (ie a maximum annual employer-paid contribution of $8,500 currently). The 10% contribution rate would be applied to lower levels of earnings, to ensure that lower income earners were not burdened by Super Guarantee contributions (which effectively would reduce gross paid earnings by more than 10% of salary). The $8,500pa Super Guarantee contribution limit would be applied to earnings above Full-time Adult Average Ordinary Time Earnings. Super Guarantee contributions would continue to be paid by each employer on behalf of each employee, be tax deductible to the employer, and taxable at 15% on receipt by the person's super fund as currently.

Superannuation Contributions above $8,500pa

Having established (through the 3 Pillars above) an adequate, equitable and cohesive system for the provision of the essential retirement needs of shelter and income adequate for a person to provide for their water, food and clothing (plus a lump sum for an additional 50% of Age Pension income amount to meet additional above minimum costs for a substantial period plus a further amount for capital related essentials), each person can make their own decisions as to the extent of additional savings which they will accumulate from the person's after tax earnings. Because most such persons will be earning incomes above Full-time Adult Average Ordinary Time Earnings, there is no need to consider these additional savings as part of the review of retirement incomes. Such additional contributions would not be tax deductible to either the employer or to the person. Current (after-tax) contribution limits could continue to apply, as would current concessional tax arrangements for investment income within the superannuation fund (a tax rate of about 5% to 10% of investment income on average during accumulation and no tax after retirement), meaning that the payment of after-tax contributions to superannuation could be expected to continue, especially for Australians above say age 45.

2. Principles for Assessing the Retirement Income System

Beyond the principles of Adequacy, Equity and Cohesion which are considered above, it is important that the Retirement Income system is both Sustainable (from both the Commonwealth Government Budget and financial markets points of view), and has a Positive Relative Effect on the Australian Economy Overall. Each of these is considered below.

Sustainable

With increasing pressure on Government budgets (arising from lack of revenue growth combined with increasing expenditure from many sources), it is clear that unnecessary areas of Government expenditure need to be wound back responsibly. For retirement incomes, the two main choices are either to tighten means testing of the Age Pension, or to reduce the extent of superannuation-related tax concessions. **A Fact Base needs to be developed to compare the economic, financial**

markets, and retirement income related effects of these two alternatives for sustainability of the retirement income system from a Federal Government budget point of view.

The proposals outlined above involve a reduction in tax concessions for employer-paid (and for self-employed) superannuation contributions, which will increase materially the sustainability of the Retirement Income system.

The remainder of this submission assumes that reduced tax concessions for superannuation contributions will ensure the sustainability of the retirement income system.

Positive Relative Effect on Australian Economy Overall

(a) Flexibility to implement Economic Stimulus or Restraint - Retirees

Current excessive levels of savings in the Australian economy (and world-wide) have led to interest rates needing to be reduced to near zero levels in an attempt to stimulate consumer spending. Simultaneously, there are many demands on the Federal Government for government spending, meaning that there is little scope to increase Federal Government spending to stimulate the economy, in a way that would avoid baking-in future budget deficits. With both measures of traditional economic stimulus seemingly exhausted currently, the question arises as to whether the Super Guarantee might be used as an additional economic stimulus tool.

Analysis of Centrelink Age Pension Means Test data shows that a substantial majority of those who receive an Age Pension do not draw down their financial assets from year to year. It is difficult not to conclude that, in advising retired Australians, the financial advice and superannuation industries have an objective of retaining assets under management, and therefore advising retired Australians to restrict their spending in retirement by drawing down the current minimum amounts from superannuation and retaining invested assets outside superannuation. The evidence for this is the 20+ year delay by superannuation funds in the introduction of appropriate drawdown products.

A Fact Base needs to be developed as to the extent to which increased spending by retiree persons from their Super Guarantee assets could be expected to stimulate the Australian economy compared to the retention of those assets within superannuation.

Financial advisers who are remunerated by fees determined as a % of assets can be expected to emphasise to their clients the importance of retaining retirement assets. This material conflict of interest needs to be addressed.

A Fact Base needs to be developed covering incentives for financial planners and super funds for retention of the assets of their clients or members within savings, compared to the alternative of increasing spending.

(b) Flexibility to implement Economic Stimulus or Restraint – Employed Persons

A similar question arises as to whether the Australian economy would be stimulated if the paid incomes of persons to whom the Super Guarantee applies were to be increased by a part or all of the Super Guarantee contribution being paid as regular income. **The Fact Base related to spending by retired persons should be extended to cover employed persons also.**

Super Guarantee contributions could be made flexible at the option of each person, by establishing a level of **minimum** Super Guarantee contributions below the level of the **standard** 10% of earnings Super Guarantee contribution. The level of mandatory minimum Super Guarantee contributions could then be adjusted from time to time, consistent with the needs of the economy for economic stimulus (or even restraint). For example, if stimulus indicated that additions were required to spending by consumers, the rate of mandatory minimum Super Guarantee contributions could be reduced by an appropriate amount, consistent with the level of additional consumer spending which was required (and vice versa, as applied in the early 1990s when there was a need for reduced spending by consumers). Such determinations could be made annually either by the Government or by an appropriate independent body (eg Reserve Bank), with each person able to elect annually whether to change their Paid Earnings / Super Guarantee contribution mix or to maintain the "standard" mix.

For such a policy to be implemented, a mechanism would need to be introduced which ensured that a person who elected to have reduced Super Guarantee contributions, did actually receive as paid salary (less tax) the amount by which the Super Guarantee contributions were reduced. Computerised payroll means that this flexibility should be able to be accommodated easily and with minimal administrative cost, assuming that a sufficient minimum notice period is required to enable the necessary payroll administration to be completed.

(c) Consistency with Australia's Capital Formation Needs and Currency Stability

At 30 June 2019, total Australian listed equities were capitalised at $1.9 trillion. Total superannuation assets were $2.9 trillion at 30 June 2019 showing that by 30 June 2019, superannuation assets had already outgrown the capacity of the Australian listed equities market (without even allowing for the material projected increase in superannuation assets over the next 10 years). There are no current constraints on the way in which Australian superannuation assets are invested. Little of these superannuation assets is invested in loans to Australian businesses, or in equity in unlisted smaller Australian businesses. As superannuation assets have increased, problems related to the availability of suitable investments in Australia have been solved by superannuation funds investing in a wide range of asset classes outside Australia.

This Retirement Income Review needs to develop a Fact Base around whether there are currently unmet capital formation needs in Australia which are constraining the Australian economy, and if there are unmet capital formation needs, the Fact Base needs to include the reasons that the investment of Australian superannuation funds is currently not meeting these needs. The Fact Base needs to consider the operation of trustee law to the investment of superannuation assets.

The Fact Base covering capital formation needs would also determine whether current retirement income policy settings are likely to result in an increased percentage of superannuation assets being invested outside Australia in future (due to limited investment markets in Australia), and the potential effects on the Australian economy and the Australian currency which would result from such substantial amounts being invested outside Australia.

Rob Paton

rjp1310@optusnet.com.au