Retirement Income Review

Submission by David Rush, BEc, FIAA

January 2020

About the author

I am a semi-retired actuary, having qualified in 1985. While most of my working life has been involved in other areas, I have taken an interest in retirement incomes, particularly having recently entered that stage of life myself. As an actuary, I am particularly interested in fairness, and would therefore look for such characteristics in any retirement incomes system.

I most recently authored two papers presented at the Financial Services Forum of the Actuaries Institute (in 2016 and 2018):

- 'A Different Approach to Meeting Changing Needs in Retirement' (2016) (http://www.actuaries.asn.au/Library/Events/FSF/2016/RushPainoRetirement.pdf); and
- 'A Product to Meet Changing Needs in Retirement' (2018) (http://actuariesinstitute.cmail20.com/t/i-i-bikdiul-l-i/).

I also made a submission on the recent changes to the means test rules for retirement income products (David-Rush-Means-Test-Rules-for-Lifetime-Retirement-Income-Streams-January-2018-Submission.pdf (37.1 kB)).

Structure of this Submission and Summary of Recommendations

This submission deals with the following specific issues:

- Means Testing (page 3);
- Tax Concessions on Superannuation (page 4);
- Owner-Occupied Property (page 7);
- Longevity and Income Streams (page 8);
- Measures of Adequacy (page 9);
- Measures of Equity (page 10); and
- Measures of Sustainability (page 11).

There are essentially three recommendations in this submission:

- Abolish the means test for the age pension, and make the provision of retirement income under Pillar 1 universal;
- Replace contributions tax and the tax on investment earnings by a full tax on retirement income at marginal rates; and
- Include the family home in the means test, or fully tax the income thereon (whether real or deemed) at marginal rates.

These recommendations would still encourage the insurance of longevity risk. In addition, the equity and sustainability of the system would be improved by them. Finally, consistency is needed in the assessment of adequacy.

Means Testing

Pillar 1 of the retirement incomes system – a government funded age pension – is means tested. As a result, it integrates with the other two pillars – compulsory superannuation and voluntary savings. The more that is held in the other two pillars, the less that is provided under the first pillar.

The argument for means testing is that it ensures that the benefits of a safety net (which the first pillar is intended to provide) are provided to those who need them - in order to provide a safety net, the benefit needs to be appropriately targeted.

The problem with means testing is that it results in the system being inherently unstable. As reliance is placed on one pillar, so the support provided by another pillar reduces. As such, the support provided by Pillar 1 cannot be relied upon. Figure 3, and the associated interactions, demonstrates this.

In particular, equity becomes difficult to assess when there are such interactions – especially when there is not a one-for-one relationship between the provisions of each pillar – i.e. when the provision from one pillar does not reduce by the same amount that the provision from another pillar increases. Furthermore, the sustainability of the system is less clear when there are complex interactions between components.

There have been numerous suggestions made in the past that the age pension should be universal, and not subject to a means test. As well as the instability referred to above, it creates perverse situations at the margins – complex interactions may adversely influence personal behaviours. For example, there is reduced incentive to increasing total provision in retirement because to do so would decrease the support provided by one of the pillars. The benefit of extra provision is therefore diluted.

The fallacy in the argument in favour of means testing is that it sees the government's role in the provision of adequate retirement incomes as merely to provide a safety net – the bulk of the provision should be met out of private resources (superannuation or other savings). Instead of this narrow role for government in the provision of retirement incomes, it should be providing support in retirement for **all** its citizens.

This is an extension of the concept of universal basic income (UBI) post retirement. Just as numerous studies have shown that the provision of UBI is **not** a disincentive to perform additional work (paid or voluntary) – contrary to common ideology – so the universal provision of an age pension is **not** a disincentive to people saving more for retirement. Indeed, the age pension has become regarded as a right by many such that they will do what they can to maintain that right – even avoiding other sources of funding in retirement. Means testing might work if Pillar 1 is regarded as a true safety net. But while it is effectively regarded as a universal right then means testing is just complicated, and may even be counter-productive to the provision of an adequate retirement income in total.

In addition, there has been much recent talk about whether the Superannuation Guarantee (SG) – which dictates the size of Pillar 2 – should be increased. At the moment, means testing in Pillar 1 puts greater pressure for a higher SG to ensure an adequate retirement income overall. As it stands, much of the benefit of a higher SG, and reliance on Pillar 2, will be eroded as means testing reduces the provision

from Pillar 1. Without means testing, the pressure for increasing SG will reduce (and there may even be an argument for reducing SG) which will benefit businesses and wage earners now.

Admittedly, it will mean a shifting in the provision of retirement incomes from the private to the public sector. However, if SG is regarded as 'tax' – albeit one that doesn't go through consolidated revenue and is privately managed – then it is a public sector provision already. If the bulk of retirement income is to be publicly funded then both pillars should be stable – not having one increase while the other decreases.

In summary, means testing, and the resulting instability of the system, adversely affects the adequacy, equity, and cohesion of the retirement income system, and should be abolished.

Tax Concessions on Superannuation

Much is made about the tax concessions for superannuation versus tax on income, and that such concessions should be capped. Some concession is warranted for effectively locking the money up, and not having access to it until retirement.

However, it is seen as a concession when compared with:

a) the tax that would be payable if the income was received in full and not diverted into superannuation;
b) tax on other investments (superannuation is taxed less); and
c) the amount that Treasury would ordinarily receive.

Also, the tax concessions for superannuation are virtually unique when compared with the tax concessions provided to retirement incomes in other countries. Firstly, contributions are taxed (in lieu of tax on income, after which other investments are made). Then, investment earnings are also taxed. Finally, the proceeds are effectively received tax free (although they are technically also taxed as income).

An Alternative Perspective on Superannuation Tax

This contrasts with an alternative perspective (equivalent to the way superannuation is taxed in other countries). This alternative perspective sees superannuation as income deferred until retirement. In the meantime it is locked away and unavailable for immediate consumption.

If superannuation represents future income for the taxpayer then taxing it at the draw-down stage is entirely appropriate and consistent. Why should tax be paid now on income which has not yet been received by the taxpayer?

With this perspective, no tax would be paid on contributions or investment earnings, but proceeds would then be taxed as income, at full marginal rates.

Progressive rates of personal income tax is a simple and effective device for achieving an equitable redistribution of income. Those who receive more income in retirement than others would be taxed at higher rates – as is the case pre-retirement.

When we treat some forms of income differently then there are inevitably consequences - costs, complexities, distortions and anomalies.

Taxing superannuation at marginal rates when it is consumed would also negate the arguments that superannuation tax concessions are too generous. A simpler taxation system is also likely to make it more cohesive.

A consequential benefit of this approach would be that any amount removed from the superannuation system would be fully taxed at marginal rates. The greater the rate of draw-down, the higher the tax. In particular, amounts removed as a lump sum would be discouraged. For example, passing the money on as an inheritance would crystallise the income as a lump sum, and be taxed accordingly. Tax would thus be optimised when the draw-down is aligned with the purpose for which it is intended – providing income in retirement.

The fact that many retirees wish to pass some of their superannuation on as an inheritance, and that there has been historically a slow take-up of pooled lifetime products which insure longevity risk (see section below on Longevity and Income Streams), suggest that the purposes of superannuation are not well understood.

Dealing With Reduced Revenue

An argument against this perspective is that Treasury would suddenly lose the revenue that it currently gets from tax on contributions and investment earnings. However, what if Treasury took a typical accounting view (with assets and liabilities), rather than just looking at the budget from a revenue and expenses perspective?

A problem with the current perspective is that any concession is seen as a loss to revenue. This disregards the fact that the purpose of a concession is to boost retirement income. The Consultation Paper notes that 'compulsory superannuation has resulted in households on average having more wealth at retirement today than in the past'. Households would have even more if it were not for taxes on superannuation contributions and investment earnings. If that higher retirement income was fully taxed when received then the higher revenue in future would compensate for the reduced revenue now.

The trillions of dollars in superannuation funds is evidence that retirement incomes will be received - and taxed - in due course. The problem is therefore mislabelled - it is not about loss of revenue, but about loss of cash flow to fund immediate expenditure.

Many of us (individuals and companies) are in the same position, being asset rich but cash poor. The accepted solution is to borrow, using existing assets as security. As long as we don't gear ourselves too much, the cost of servicing the debt and the associated risk is considered acceptable.

Government debt is often viewed as unsecured. However, if Treasury viewed tax on retirement incomes as an asset against which borrowing could be secured, then maybe it would be less averse to using debt to fund other budget expenditure (such as that on infrastructure).

Under this alternative perspective, it becomes obvious that superannuation can be taxed equitably at the draw-down stage without depleting short term government cash flow. The solution is to abolish tax on super contributions and earnings, to tax

retirement incomes at marginal rates, and to borrow to meet cash flow inadequacies in the meantime.

In return super funds should be required to apply a proportion of the growth in their accumulated assets (say 15%) to acquire government debt, secured against the future tax in respect of those assets. This might sound similar to the old 30:20 rule, but is different in the following respects:

- The amount of debt on issue would be linked to the volume of superannuation assets - minimising bond market demand and supply imbalances and keeping the government's gearing within acceptable limits;
- Once acquired, super funds need not retain the debt. It could be on-sold to others (e.g. annuity funds) for whom it provides a better match. As such, investment choices in superannuation funds need not be constrained;
- As funds declined, the debt would be redeemed, although for expediency such redemption might be offset against tax payable on draw-down; and
- The same rules would apply to annuity funds (i.e. annuity payments would be taxed as income at marginal tax rates and annuity funds would be required to hold a minimum proportion of their assets in government debt) – they would all (superannuation and annuities) be part of the one process.

This approach offers a simple solution for cleaning up the legacy of past superannuation tax structures. Funds could be given a one-off issue of government debt as compensation for taxes already paid, and for any concessions which still need to be "grand-fathered". This would be applied to increase the accounts of current members, which would then be subject to full tax at retirement, thus eliminating the need for funds to maintain detailed records into the future.

As noted previously, the proceeds from this secured debt would provide a ready source of funds for other immediate budget expenditure, such as infrastructure.

Owner-Occupied Property

There has been much debate over whether the family home should or should not be included in the means tests for the age pension. Many retirees are deemed to be 'asset rich' because of their ownership of the family home. Converting that into an alternative income-producing asset would reduce their reliance on the age pension. Including that asset in the means test, to some extent, would force that to happen, as the asset might as well produce income to offset the lost income from Pillar 1. However, the family home is clearly a sensitive and sentimental subject.

If the retirement income provided under Pillar 1 was made universal, such that means tests were not needed, then the question would become moot. There may be social arguments for saying that retirees should have accommodation that is of an appropriate size. But, if they choose to hold a non-income producing asset, and just rely on other sources of retirement income, then that is arguably their prerogative.

An alternative would be to deem a level of income from such assets, in the same way that there is already deeming in respect of other assets (such as bank accounts). At the moment such deemed income is included in the means tests under Pillar 1. If the retirement income provided under Pillar 1 was to be universal, then existing deemed income and deemed income from the family home could be taxed at marginal rates. That would:

a) Be considered fair – income from larger properties (whether real or deemed) would be taxed more; and
b) Provide appropriate incentives – if tax is to be payable then the asset might as well produce real income, or be converted to one which does (e.g. through a reverse mortgage).

In summary, the family home should either be included in the means test, or the income thereon (whether real or deemed) should be taxed at full marginal rates.

However, until there is equivalent treatment of owner-occupied property pre-retirement (and mortgage repayments on that asset), there will be resistance.

Longevity and Income Streams

It is noted in the Consultation Paper that, historically, there has been little insurance against longevity risk in the retirement income provided under Pillars 2 and 3, leaving the government to effectively insure against longevity risk via the safety net of the age pension provided under Pillar 1.

Recently, there have been moves to encourage the provision of income streams (known as ‘pooled lifetime products’), which address longevity risk, under Pillars 2 and 3. However, this has been done via the means test under Pillar 1 – i.e. the government has been prepared to provide greater retirement income under Pillar 1, if longevity risk is appropriately addressed in the income provided under the other two pillars.

As noted above, means testing of the income provided under Pillar 1 is complex, and produces perverse interactions. Inclusion of pooled lifetime products at concessional rates in those tests just adds to that complexity. Removing those means tests entirely would reduce this complexity and ensure that a minimum level of retirement income is provided to everyone, regardless of their longevity.

Rather than use the means test to reduce the payments by the government, the alternative is to provide that payment to everyone and to fund that additional expense by ensuring that retirement income is appropriately taxed (see my proposals above re Tax on Superannuation). If it is felt that pooled lifetime products are to be encouraged, then the income produced by them could be concessionally taxed.

(As per my previous submission on the new means test rules, I would advocate that these tax concessions only apply to income received at an advanced age – as it is the income received at these advanced ages which is to be encouraged – prior to that, no incentive is needed and revenue received from the appropriate taxation of income will fund the universal provision of income under Pillar 1.)

Note that my proposals re Tax on Superannuation (that it just be taxed at marginal rates when it is actually received) should also help to incentivise pooled lifetime products. This is because forfeiture (which is the main way in which longevity risk is insured and income continues to be provided to those who survive) is not taxed. However, if longevity risk is not insured, and the retiree just draws income as long as that pool lasts, then that pool will ultimately be taxed – even more so if it is ultimately passed on as inheritance. Furthermore, if longevity is insured, there may be more tax at advanced ages (unless there are concessions) but there will also be more income – the overall net income to retirees will be higher.

The advantages identified in my previous submission – particularly those relating to neutrality, equity, resilience, integrity of the social security system, fiscal sustainability of the social security system, and simplicity – would apply.

In summary, insurance of longevity risk should be encouraged and this can be achieved without a means test and if retirement income is fully taxed at marginal rates.

Measures of Adequacy

This submission does not advocate whether an absolute or relative measure of adequacy should be used. However, consistency is needed in the way in which it is employed.

In particular, there is currently debate around the appropriate level of SG under Pillar 2.

If the view is that the SG (at whatever level) produces an 'adequate' level of retirement income then that level must be a relative measure. This is because the SG is expressed as a percentage of (pre-retirement) income. As such, when accumulated over a fixed working life, and then de-accumulated over the average retirement span, it must produce a level of retirement income which is itself a percentage of pre-retirement income – i.e. the resulting retirement income, if adequate, must be relative.

It is therefore inconsistent to compare a component of the system (i.e. Pillar 2) which produces a relative retirement income (i.e. a percentage of pre-retirement income) against an absolute measure of adequacy. The result will clearly be more than adequate for those with a high pre-retirement income, and less than adequate for those with a low pre-retirement income. Conversely, to produce a retirement income which is considered adequate in an absolute sense will require a low SG for those with high pre-retirement income, and a high SG for those with a low pre-retirement income.

To provide a consistent outcome, then a retirement income that is adequate in relative terms will require an SG that is similarly expressed in relative terms. Conversely, a retirement income that is adequate in absolute terms will require an SG that is similarly expressed in absolute terms – i.e. it will require an SG that is a fixed dollar amount, not a percentage of income.

Consistency is also needed between pillars. E.g. Pillar 1 produces a retirement income which is (at its maximum level) independent of pre-retirement income – i.e. its adequacy will be measured in absolute terms. Pillar 2 produces a retirement income which essentially (ignoring caps on contributions) is linked to pre-retirement income – i.e. its adequacy will be measured in relative terms. How is the adequacy of the income that results from the combination of those pillars to be measured? And what of interactions between those pillars?

Without some alteration, the adequacy of the system as a whole will be difficult to measure. But, however it is done, consistency is needed.

Measures of Equity

Although it is not mentioned in the Consultation Paper, the total retirement income received by two identical individuals should be the same, regardless of the pillars from which that retirement income is provided.

In particular, I've previously mentioned the problems caused to equity by means testing. Ideally, those two identical individuals should receive the same amounts from each of Pillars 1, 2 and 3.

In that regard, I would also be of the view that:

- The system should deliver similar outcomes for individuals who have the same lifetime income, regardless of how they are employed; and
- The system should deliver similar outcomes for individuals with similar levels of total wealth, regardless of how their assets are held.

This will affect limits and interactions which invariably create distortions and inhibit equity.

It will be easier to achieve equity if the purpose of Pillar 1 is clarified. At the moment there is confusion over whether Pillar 1 represents the public component of retirement income provision or a safety net. The achievement of equity will be easier and clearer if Pillar 1 is a component of retirement income provision available to all (i.e. without means testing).

The provision of an (arbitrary) adjustment for those who don't own their own home will clearly be inequitable where the family home is worth more than the adjustment (only $210,000 – which will be exceeded by the value of the property, or the amount of a mortgage, in most cases). It will be much more equitable to include the full value of the family home in the means test, or to include income thereon in taxable income. That way, those who don't own their home will get the full benefit to which they are entitled.

Despite Pillar 1 being effectively a safety net, and other caps being applied on concessions, greater concessions are provided to those on higher incomes (see Figure 4). However, this comes back to the issue of consistency. If adequacy is measured in relative terms, but concessions are measured in absolute terms (as is the case with the Y-axis in Figure 4) then it is inevitable that those on higher incomes will receive more concessions if a retirement income is to be achieved that is considered adequate in relative terms.

To the extent that a safety net is needed, this should be provided separately through the social security or taxation system (as is done pre-retirement). Note, also, that this will be easier to achieve if – as I propose earlier – retirement income is fully taxed at marginal rates, just like income received pre-retirement.

The assessment of equity post-retirement should be no different than it is pre-retirement – the retirement income system should be no more or less equitable.

Finally, the Consultation Paper makes the point that ‘the retirement income system should support individuals to save enough to allow consumption smoothing over their lifetime without deferring too much consumption to their retirement at the expense of living standards during working life’. A common argument for reducing (or at least not increasing) the rate of SG is that doing so will increase the levels of take-home income – particularly for low wage workers. That might well be the case now. But it will reduce the level of retirement income for such workers. It is likely that the level of pre-retirement income already exceeds the level post-retirement. Reducing the level of SG will just make this ratio worse, and so adversely affect this measure of equity.

In summary, abolishing the means test and taxing retirement income in full at marginal rates would make the system more equitable.

Measures of Sustainability

A system with fewer interactions will be less susceptible to environmental changes (such as demographic mix or longevity) and so will be more sustainable. Hence, removing things like means tests, with an adequate retirement income provided to all, should improve sustainability.

This is even more so if retirement income is provided by the individual receiving it (as is the case with provisions from Pillars 2 and 3). Provisions from Pillar 1 are less sustainable if there is a change in demographic mix (with more retirees and fewer taxpayers to support them). However, that is because of the current view on the budget, which only considers current revenue and expenses. If retirement income is fully taxed, and that potential tax revenue is viewed as an asset, then the provision of adequate retirement income should be self-sustaining, regardless of any demographic shifts.

Finally, the system will be less sustainable if it is used for more than its intended purpose. Thus, if the superannuation system is used for the provision of additional aged care or health care, wealth accumulation or estate planning, rather than solely for retirement income purposes, then it is likely to be less affordable in the long term, and so less sustainable.

In summary, abolishing the means test and taxing retirement income in full at marginal rates would make the system more sustainable.