5. COHESION

Outline of this chapter

This chapter examines whether the retirement income system is functioning cohesively. It examines whether the three pillars are effectively integrated and the retirement income system is functioning cohesively against three of the suggested elements for the system's objective (see *1C. The objective of the system and the roles of the pillars*). That it should:

- Have effective incentives to smooth consumption and support people in taking personal responsibility for their retirement incomes
- Interact effectively with other systems
- Not be unnecessarily complex for consumers

These elements are interlinked. Unnecessary complexity can undermine the effectiveness of incentives to smooth income and consumption over a lifetime. Similarly, interaction with other systems, such as the health or aged care systems, can lead to additional complexity.

The chapter also explores the implications of changes to the Age Pension means-testing arrangements on the performance of the retirement income system. Consideration is given to the effects of changing the Age Pension assets test taper rate or merging the Age Pension assets and income tests. These issues were raised in submissions.

Section 5A. Cohesion

Box 5A-1 Section summary

- **With the maturing superannuation system, compulsory superannuation is effective at helping most people save enough for an adequate retirement income, when combined with the Age Pension**. The opportunity to make voluntary superannuation contributions provides sufficient flexibility to achieve a higher level of superannuation savings for those with the means to do so.
- **Financial incentives to save for retirement, or to encourage older Australians to continue to work, appear to have limited effect on retirement outcomes.** Tax concessions tend to lead people to reallocate rather than increase savings, and evidence that the Age Pension means test affects savings behaviour pre-retirement is weak. Incentives for people to remain in the workforce tend to benefit those who would have worked without the incentive.
  - Few middle- to lower-income earners make voluntary contributions to their superannuation.
  - Personal budget constraints are the main reason people do not save more for retirement. When deciding to retire, people mostly consider the superannuation preservation and Age Pension eligibility ages and factors outside the retirement income system, such as health.
- **There is little evidence people structure their superannuation withdrawals to access the Age Pension.**
- **Incentives to draw down assets to finance living standards in retirement are not effective.** The majority of people are not using their superannuation balances and other savings effectively to maintain their living standards in retirement. If they did so, they could achieve the same retirement outcome with a lower level of saving and higher standard of living in their working life.
  - Retirees are concerned about outliving their savings and tend to spend less rather than use products to manage this risk.
  - Prescribed minimum drawdown rates anchor behaviour and reinforce a tendency to conserve superannuation savings. Without a change to drawdown behaviour, bequests from superannuation will grow.
  - The Age Pension means test taper rate does not appear to have a strong effect on whether people draw down or consume their assets.
  - People are less likely to consume savings that are framed as assets as they have been primed during working life to save this ‘nest egg’. Expressing superannuation balances in terms of retirement income, in a similar way to working life income, may encourage people to draw down from their savings in retirement.
  - Precautionary saving for aged care costs appears to inhibit some people from drawing down assets. They appear to be unaware of the extent to which these costs are subsidised by Government.
  - Both the tax and retirement income systems encourage investment in the principal residence. But few people draw on the equity in their home to boost their retirement income.
  - Surveys suggest leaving bequests is not the highest priority of retirees. But most people leave a significant share of their retirement savings as a bequest, often unintentionally.
- **System complexity prevents people optimising their retirement income.** Navigating different parts of the retirement income system, combining income sources and managing the multiple risks faced in retirement is challenging. People need assistance with complex financial decisions. Interactions between the retirement income system and other systems, such as the aged care system, increase complexity.
- **People lack an adequate framework to guide their decision-making in planning for retirement and when in retirement.** The current financial advice regime is not meeting people’s needs. People struggle to achieve a stable income in retirement. Superannuation funds play only a limited role in informing and guiding people to get better retirement incomes from their savings. Current regulatory barriers impede

funds from providing cost-effective guidance and advice about retirement. The proposed Retirement Income Covenant envisages creating a legal obligation on superannuation funds to consider their members' needs in retirement.

- **Evidence suggests the retirement income system could be more cohesive and simpler for people to engage with.**

Outline of this section

This section considers the cohesiveness of the:

- **Pre-retirement phase**: the incentives to save and invest for retirement and the role of the Superannuation Guarantee (SG), along with the incentives to continue to work
- **Retirement phase**: the incentives and support for retirees to optimise their assets to fund their living standards in retirement

Box 5A-2 Stakeholder views on cohesion of the retirement income system

Most submissions discussed the importance of the principle of cohesion. In general, stakeholders were concerned about the lack of cohesion between the three pillars: the Age Pension, compulsory superannuation, and voluntary savings, arguing that policy and regulation for each pillar were developed in isolation. Some stakeholders expressed concern about a lack of continuity between the pre-retirement and retirement phases.

Pre-retirement phase. Many stakeholders noted the SG plays a key role in ensuring people are saving for their retirement. They had mixed views about whether tax concessions for voluntary superannuation contributions had the same effect. A few stakeholders considered tax concessions essential to the superannuation system's design. One submission noted superannuation tax concessions are:

'…an "incentive" to save and an "investment" that will yield future returns in terms of less pressure on the budget and productive investment of superannuation savings in the economy, in turn leading to higher tax revenue.'
(Self-managed Independent Superannuation Funds Association, 2020, p. 14)

In contrast, some stakeholders claimed the tax concessions benefit higher-income earners disproportionately and do little to encourage lower- and middle-income earners to save. One submission stated:

'The tax incentives support groups which are already pre-disposed to take advantage of them, and it appears that they are supporting those with higher incomes who are already likely to save, rather than incentivising additional saving.'
(First State Super, 2020b, p. 29)

Most submissions discussed the impact of the Age Pension means test on savings behaviour pre-retirement. Stakeholders suggested the Age Pension assets test taper rate can be a disincentive for saving for retirement.

Retirement phase. Some stakeholders noted retirees are underspending in retirement, rarely consuming their capital and drawing down only the earnings from their assets. They are also reluctant to draw on home equity to fund retirement:

'…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.'
(Monash Centre for Financial Studies, 2020, p. 2)

A few stakeholders suggested the fear of running out of money in retirement drives conservative drawdown behaviour for retirees. Some stakeholders attributed this behaviour to a lack of retirement income products that provide longevity risk protection along with low levels of financial literacy, which acts as a barrier to engagement.

The majority of stakeholders considered the system is too complex for people to navigate. They considered that system defaults, automation and data sharing were important to reduce complexity and achieve better retirement outcomes. One submission stated:

> *'…we are in favour of strong default structures, so people don't need to make decisions in complex areas (nor be forced by complexity to pay financial advisers to assist them within the mandatory system).'* (Rice Warner, 2020, p. 5)

Some stakeholders considered financial advice to be critical to making better decisions and reducing worry and uncertainty in retirement. However, they noted people were deterred from accessing personal financial advice because of its high cost and unclear benefits, and their distrust of the financial advice industry. Some stakeholders suggested the type of financial advice people need has changed over time and demand for financial advice will increase in future. They argued the superannuation industry should play a greater role in providing financial advice. One submission noted the benefits of superannuation funds providing ongoing information and regular updates to members on likely retirement incomes. Other submissions suggested that regulations on intra-fund advice, which limit cross-subsidising financial advice costs, are a barrier to fund involvement. Others thought appropriate defaults and system simplification would reduce the need for financial advice.

Cohesiveness of pre-retirement settings for saving and investment

For most people, the pre-retirement phase is characterised by defaults[275] and compulsion, such as compulsory superannuation with the SG, and default enrolment into an employer's fund and MySuper products. These defaults are highly regulated. For example, a MySuper product is 'a simple, well-designed product suitable for the majority of members' (Super System Review, 2010, p. 1). Defaults in the pre-retirement phase have allowed a large proportion of the population to grow their superannuation savings in a simple product without needing to make complex choices.

Defaults and compulsion have been effective in increasing household savings. The introduction of compulsory SG increased retirement savings. Superannuation is now the second-largest asset for most people, after the home (ABS, 2019k). Studies have consistently found that the SG has increased household net wealth (Connolly, 2007; Ruthbah & Pham, 2020a).

Research commissioned by the review found the SG crowds out private savings in the short term but increases wealth in the long term. Some substitution appears to occur between compulsory superannuation and private household saving, but this effect is small. Estimates suggest that, for every dollar increase in compulsory superannuation, households reduce their private saving by 43 cents, meaning total household savings are higher overall (Ruthbah & Pham, 2020a).

The policy settings in the pre-retirement phase have changed over time to ensure they function as intended and better reflect the needs of consumers. Stakeholders have proposed further changes:

- **Changes to the SG.** Beyond changes to the rate (see *2D. Policy scenario: Implications of maintaining the SG rate*), some stakeholders proposed introducing more flexibility around its application; for example, by allowing people to opt in or out of SG increases.
- **Changes to default fund and product selection.** The Productivity Commission (2018a) found the current default mechanisms for selecting superannuation funds and products are too variable and lack accountability. The Commission proposed winding back some of the default settings and encouraging members to make more active choices on these issues. It suggested members would be assisted by a 'best in show' shortlist of superannuation products, supported by an 'outcomes test' to prove product quality. Some stakeholders also suggested rolling out the

[275] Default options are pre-set courses of action that take effect if people do not make a decision (Thaler & Sunstein, 2008).

> Consumer Data Right to the retirement income sector and introducing more digital literacy and engagement tools to improve consumer choice (Diversa Trustees - A Sargon Business, 2020, p. 3).

By influencing behaviours and outcomes, defaults deliver reasonable outcomes to the point of retirement for most people. However, relying on defaults can lead to low engagement, which can lead to low levels of consumer-driven competition (Productivity Commission, 2018a). The Productivity Commission found that superannuation fees have not come down as much as expected, some funds are underperforming, and the default system does not deliver reliable outcomes. A sizeable minority of people are defaulted into underperforming funds, leading to worse outcomes at retirement (Productivity Commission, 2018a).

The Productivity Commission (2018a) also found that ‘choice members’ (people who choose their own superannuation product) do not get better outcomes in retirement on average. Stakeholders have suggested better financial literacy as one way to improve engagement and retirement outcomes. This is discussed below in *Cohesiveness of the retirement phase*.

Financial incentives to work and save

Not everyone is covered by the SG and some people may want to save more than the SG rate. The retirement income system provides incentives to encourage people to work, save and take an active role in planning for retirement. However, evidence suggests these incentives have limited effects on overall savings.

Tax concessions for superannuation

Tax concessions are offered on both compulsory and voluntary superannuation contributions, although they only operate as an incentive for voluntary contributions. Voluntary contributions can be made pre-tax (concessional) or post-tax (non-concessional) (see *Box 5A-3* and *1B. Design of Australia’s retirement income system*).

The tax rate on voluntary concessional contributions may be higher or lower than 15 per cent, depending on the person’s taxable income. The main way people access voluntary concessional contributions is through salary sacrificing.[276]

Although non-concessional contributions do not receive a contributions tax concession, they benefit from investment earnings being taxed concessionally at a headline rate of 15 per cent. However, the *effective* concessional tax rate for earnings is often lower than 15 per cent. Dividend imputation[277] and the 33 per cent capital gains tax concession for assets held in a superannuation fund for more than 12 months reduce the tax paid by the fund. As a result, modelling for the review assumes a 7 per cent effective earnings tax rate (see *Appendix 6A. Detailed modelling methods and assumptions*).

[276] Although some concessional voluntary contributions are made via personal, deductible superannuation contributions.
[277] Dividend imputation allows some or all of the tax paid by a company to be attributed (imputed) to shareholders as a tax credit. In Australia, the corporate tax rate for most companies is 30 per cent while superannuation investment returns are taxed at 15 per cent.

Box 5A-3 Tax concessions for voluntary superannuation contributions

Pre-tax (concessional) contributions

- A concessional tax rate of 15 per cent applies to both contributions and investment earnings, such as interest, dividends and rental income.
- Concessional contributions are capped at $25,000 a year. A carry forward rule allows people to make additional contributions for unused amounts from the last five years (for superannuation balances less than $500,000).
- Tax concessions are reduced for those with very high incomes through Division 293 tax, with the current threshold set at $250,000 of combined income and contributions. Division 293 charges an additional 15 per cent tax on either superannuation contributions or the amount over the threshold, whichever is lower.
- Excess contributions are taxed at the marginal tax rate.
- Contributions by lower-income earners, especially those below the tax-free threshold ($18,200 in 2018-19) are effectively tax-free. Any tax payable is offset by the low income superannuation tax offset.

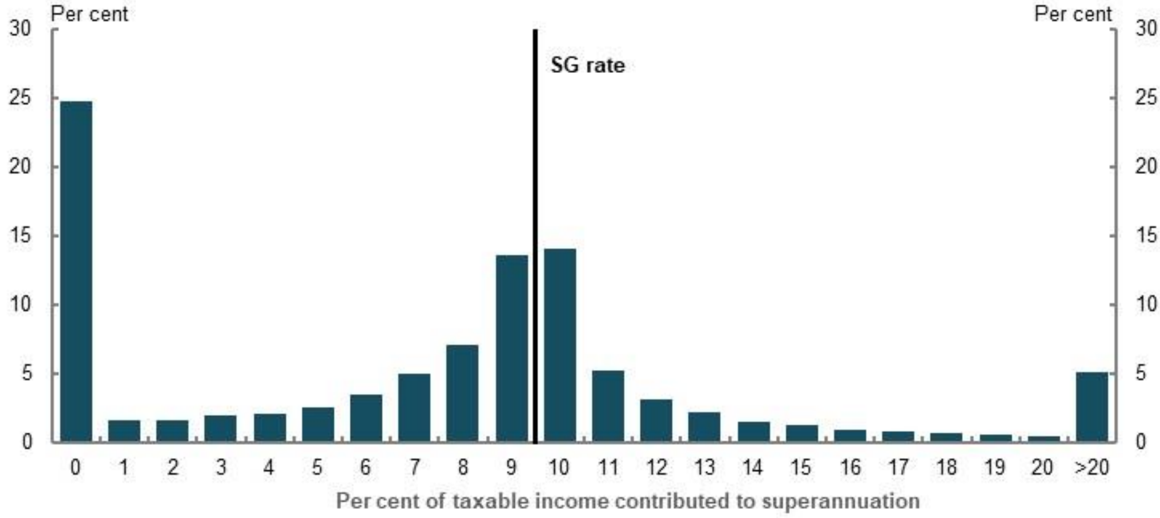
Post-tax (non-concessional) contributions

- Post-tax contributions are made after income tax has been paid at the person's marginal income tax rate. But investment earnings are taxed concessionally at 15 per cent.
- Non-concessional contributions are capped at $100,000 a year. Beyond this, they are taxed at 47 per cent if excess contributions and earnings are not withdrawn. People under 65 may be able to bring forward up to three years of non-concessional contributions, depending on their superannuation balance.
- The Government makes a 50 per cent co-payment for post-tax contributions by lower- to middle-income earners, capped at $500.

About 17 per cent of workers are self-employed. **Self-employed people are not covered by the SG**, and only around a quarter of them make a voluntary contribution in a given year. As a result, self-employed people generally have lower superannuation balances than employees. However, they have similar levels of overall wealth. They typically have access to other tax-effective avenues to save for retirement and hold more savings in property and business assets than employees (see *3D. SG coverage*).

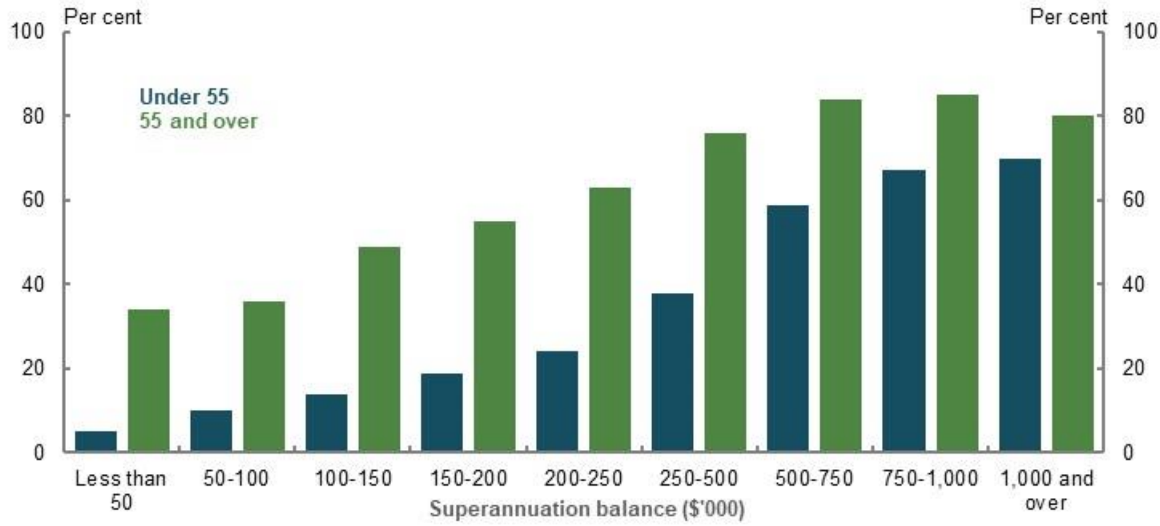
Around a quarter of people make voluntary superannuation contributions (ATO, 2019f). Most people make pre-tax superannuation contributions at or near the SG rate (Chart 5A-1). However, for higher-income people, older people and those with higher superannuation balances, voluntary contributions make up a large proportion of total annual contributions (Chart 5A-2) (see *3A. Income and wealth distribution)*.

Chart 5A-1 Distribution of concessional superannuation contributions among taxpayers



Source: Analysis of ATO individual income tax returns and member contributions statements, 2017-18.

Chart 5A-2 Voluntary superannuation contributions as a proportion of total contributions, by superannuation balance



Source: Analysis of ATO individual income tax returns and member contributions statements, 2017-18.

In general, tax concessions appear to be of limited effectiveness at encouraging *additional* savings or increasing people's overall savings. Instead, tax concessions appear to mostly encourage people to *reallocate* existing savings, or savings they would have made in any case, into superannuation. Some studies find a small, positive effect of tax incentives on overall savings. Others find no significant effect (Table 5A-1). Those finding a small positive effect generally agree that this applies only to lower- and middle-income earners: a group that makes relatively small voluntary contributions (see *3A. Income and wealth distribution*). Most of the contributions are made by higher-income earners, and may represent reallocation of savings that would have probably occurred with or without the tax concessions (OECD, 2018a). Although Australian evidence on the overall effect on savings is not definitive, it suggests the impact is small.

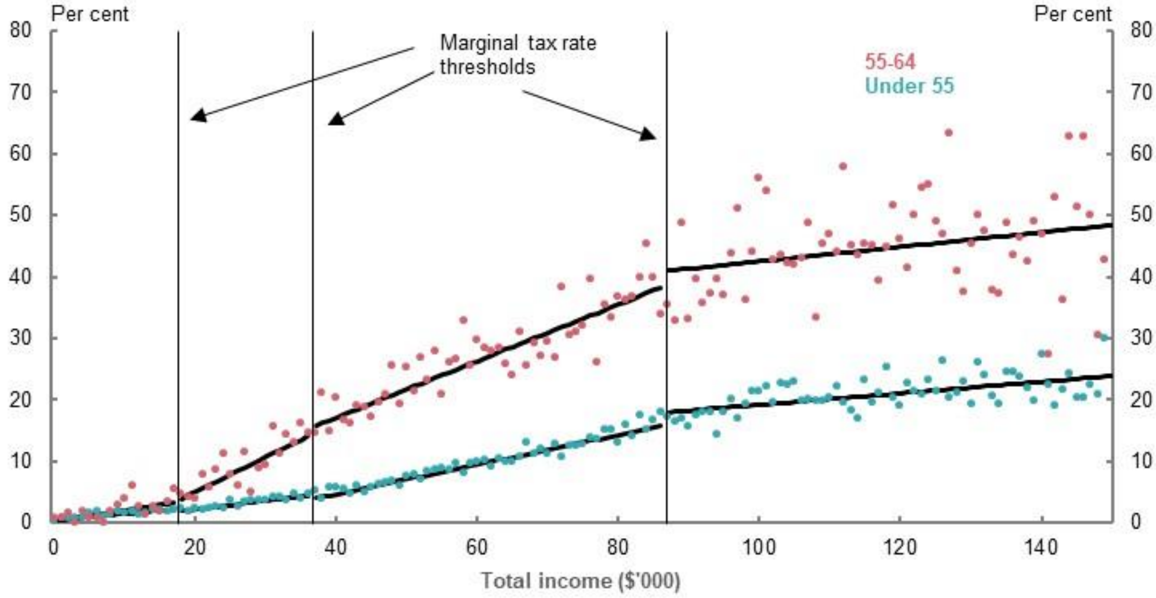
Policy settings are particularly relevant when considering if international findings can be generalised to Australia. For example, many studies use US data on 401(k) retirement accounts to measure the combined effect of tax incentives and the offer of the plan from an employer. In Australia, most people are compelled through the SG to both open an account and contribute at a relatively high level. If Australia's superannuation tax concessions are to generate additional savings, these savings must be voluntary *on top of* the additional savings that result from the SG. Many other countries' incentives seek to elicit additional savings from a base of low or no retirement savings. Some employers offer compulsory contribution rates above the SG as part of their employment packages (Mercer, 2020). This further reduces the scope for tax concessions to generate additional savings from voluntary contributions.

Table 5A-1 Summary of Australian and international literature on the effect of tax concessions on generating additional retirement savings

Country/Paper	Finding
Australia	
Sobeck and Breunig (2020) (commissioned by the review)	Incentives from co-contribution policy have a small, positive effect on overall savings (23 cents in the dollar).
Ruthbah and Pham (2020b)(commissioned by the review)	Incentives from co-contribution policy have small, positive effects on overall savings. Division 293 tax appears to lead to a reallocation of savings with no effect on wealth. Concessional contributions caps may have marginal effects on savings and wealth.
Feng (2014)	Tax incentives have a limited effect, if any, on the level of salary sacrifice contributions.
USA	
Benjamin (2003)	A quarter of 401(k) balances represent additional private savings, mostly stemming from lower- and middle-income households.
Beshears et. al. (2017)	No evidence that contribution rates respond to the tax incentive associated with a Roth contribution option (non-deductible contributions but untaxed withdrawals, compared with deductible contributions but taxed withdrawals) on existing 401(k) plans.
Gelber (2011)	No definitive conclusion on whether 401(k) contributions generate additional savings.
Engelhardt and Kumar (2006)	Participation in 401(k) plans produces the largest additional savings for lower- and middle-wealth households.
Chernozhukov and Hansen (2004)	Participation in 401(k) plans produces additional savings, but less so for the upper end of the wealth distribution.
Engen and Gale (2000)	Savings in 401(k) accounts held by lower-income households are more likely to represent additional savings than those held by higher-earning groups.
Engen et. al. (1996)	Little, if any, of 401(k) contributions represent additional savings.
Poterba et. al (1996)	The weight of evidence is that the bulk of IRA and 401(k) contributions are net additions to savings (more recent papers have critiqued this paper — for example, Benjamin (2003) and Engen and Gale (2000)).
Other international	
Chetty et. al. (2014)	Changes to subsidies for voluntary contributions in Denmark produce only 1 cent of additional savings for every $1 of Government expenditure.
Attanasio et. al (2005)	Limited evidence that either the US or UK schemes produce additional savings.
Ayuso et. al. (2019)	On average, 19 cents in each euro contributed to the Spanish scheme represent additional savings. Contributions from households close to retirement are more likely to represent a reallocation of existing savings.
Corneo et. al. (2015)	High wealth households in Germany are much more likely to benefit from private pension subsidies.
Paiella and Tiseno (2014)	Increases in tax incentives in Italy have little, if any, effect on overall household savings.

Tax incentives have a limited effect on the decision to salary sacrifice (Feng, 2014). If tax incentives provided a strong incentive to make voluntary superannuation contributions, salary sacrifice would be expected to 'step up' at each of the marginal tax rate thresholds (and among all age groups) where people get the largest tax benefit from making salary sacrifice contributions. In fact, although salary sacrifice rates increase with income, they do not jump at the marginal tax rate thresholds (Feng, 2014, p. 65). More recent data confirms this result (Chart 5A-3).[278]

Chart 5A-3 Concessional voluntary superannuation contribution rates by income intervals and age, per $1,000



Source: (Feng, 2014) updated using ATO individual income tax returns and member contributions statements, 2017-18.

Similarly, the Division 293 tax has no impact on overall savings (Ruthbah & Pham, 2020b), suggesting either the tax rate is still concessional for very high-income earners and superannuation remains an attractive savings vehicle, and/or tax concessions have limited impact on very high-income earners' decisions to save (Table 5A-1).

The earnings tax exemption in the retirement phase is particularly unlikely to encourage additional savings. It primarily benefits people who earned higher incomes[279] over their lifetime (see Chart 3A-11 in *3A. Income and wealth distribution*). Tax incentives that benefit higher-income earners are most likely to lead to portfolio reallocation, rather than new savings. Literature on tax salience suggests the most effective incentives are ones that affect people immediately (Chetty, 2011). As the benefit of the exemption occurs in retirement, it is less likely to influence savings decisions made years earlier while people are working.

The strongest drivers of voluntary superannuation contributions are income and age, rather than tax concessions. Superannuation contributions trend with income (CEPAR, 2018a). One study found a 10 per cent increase in income lifted the likelihood of people making pre-tax voluntary contributions by more than 1 per cent (Feng, 2018, pp. 10, 13). It also found savings were closely related to age, regardless of the type of savings, with the marginal effect higher for pre-tax contributions than post-tax contributions. Similarly, a recent study using Australian tax data found people in the top superannuation balance quartile rapidly increase their contributions before retirement (Polidano, et al., 2020).

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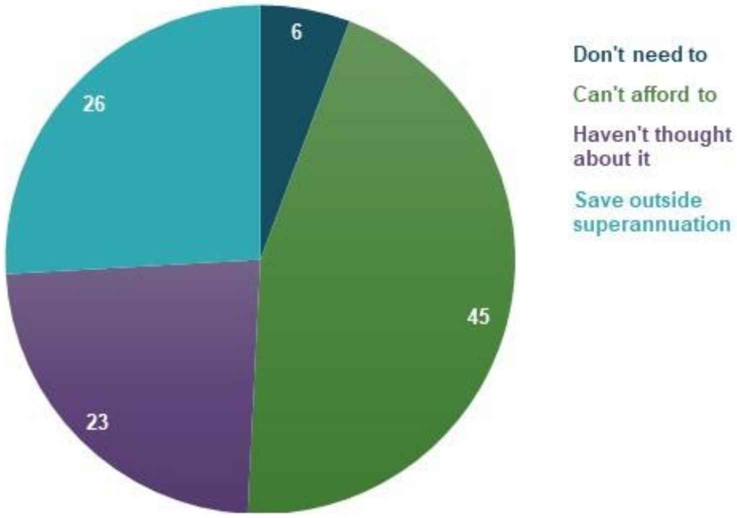
[278] In the 2016-17 tax data, the exception is for people aged 55 and over around the tax-free threshold.

[279] Lower-income earners are defined as those in the bottom 30 per cent of all earners, higher-income earners in the top 20 per cent and middle-income earners are those in between. Adjusted by the review's deflator to 2019 dollars, lower-income earners have average annual earnings over their working life of up to $48,000, while higher-income earners have average annual earnings of $112,900 and above.

The main reason people do not make contributions to superannuation is because they cannot afford to do so. BETA (Forthcoming) found 45 per cent of employees who do not make voluntary contributions say this is because they cannot afford to (Chart 5A-4). Survey data suggests this is particularly the case for lower-income earners (Feng, 2018, p. 14; Ralston & Feng, 2017). Findings from *2C. Maintaining living standards in retirement* suggest that making voluntary contributions could contribute to some people, particularly those on lower incomes, having higher living standards in retirement than during working life.

Chart 5A-4 Employees' reasons for not making voluntary superannuation contributions



Note: Based on 2020 survey data. Source: (BETA, Forthcoming).

Other reasons people do not make voluntary superannuation contributions include that they think they will have enough savings without making additional superannuation contributions, believe the SG or their spouse's superannuation is sufficient (Feng, 2018, pp. 14-15), or are saving outside superannuation. A recent survey showed that, for people who do not make voluntary contributions, between 3-6 per cent did not think they needed to make extra superannuation contributions, and 26-35 per cent used savings vehicles other than superannuation for their extra savings (BETA, Forthcoming). Self-employed people were more likely to think they needed to save more and were more likely to save outside superannuation (BETA, Forthcoming).

Almost a quarter of people who do not make voluntary contributions 'haven't thought much about saving for retirement' (BETA, Forthcoming). People stick with default saving rates in retirement programs (Shafir, 2012).[280] People may also disengage because the system is complex (Feng, 2018, p. 59; CEPAR, 2018b, p. 2). This is further discussed in *Cohesiveness of the retirement phase* below.

Tax concessions can only be an effective incentive to make additional superannuation contributions if people know about them. Survey data suggests around 21 per cent of self-employed people and 23 per cent of employees are not aware of superannuation tax concessions (BETA, Forthcoming).

Government co-contributions to superannuation

Government co-contributions have a limited impact on superannuation contribution rates. Eligible people in lower income ranges do not contribute more than those who are ineligible (Feng, 2018, p. 10). Research found a government co-contribution of $1 increased total savings by 23 cents (Sobeck & Breunig, 2020). Another study, using a different dataset and methodology, found that increases to

[280] In the US, Thaler and Benartzi (2004) identified that inertia and present bias play a dominant role in making people stick to retirement defaults. They developed a program ('Save More Tomorrow') where employees commit to linking future pay rises to increased savings rates.

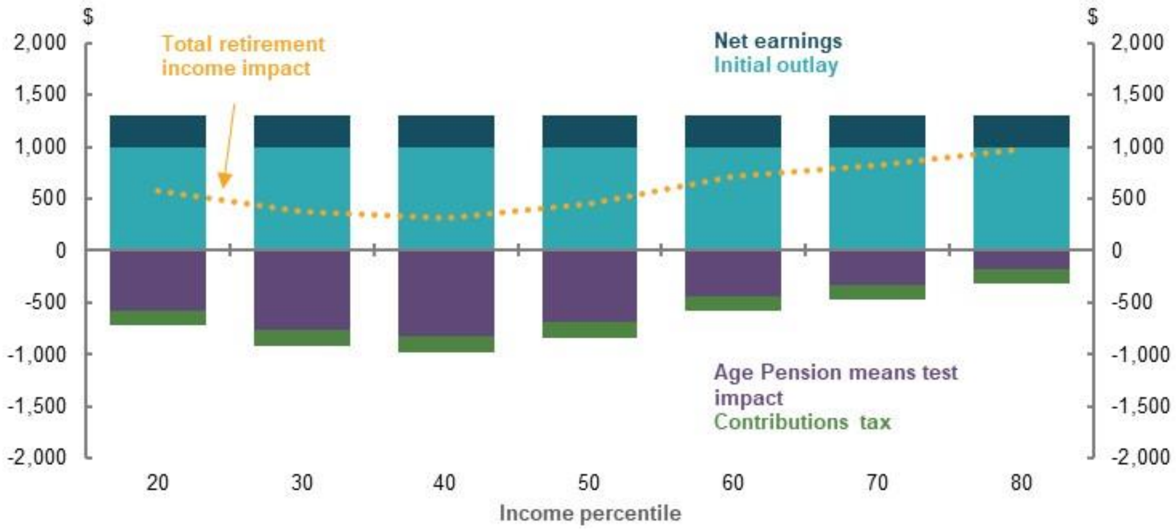
the Government co-contribution cap had a very small positive impact on household saving (Ruthbah & Pham, 2020b).

The Age Pension means test

The Age Pension means test is designed to ensure Government support is targeted to people in need by reducing a person's rate of Age Pension payable as their means increase. The current assets test taper reduces at a rate that generates high effective marginal tax rates for middle-income earners.

The impact of the assets test on retirement savings can most clearly be seen by modelling the effect of salary sacrificing $1,000 in the year directly before retirement for people from different income percentiles (Chart 5A-5). The model compares the additional income a person would get in retirement with their reduction in disposable income pre-retirement. For a median earner, retirement income only increases by around one-third of the disposable income they gave up, mostly due to the impact of the Age Pension means test.

Chart 5A-5 Effect of saving an extra $1,000 immediately before retirement, by income percentile



Note: The scenario assumes people salary sacrifice an additional $1,000 in the year before retirement. Superannuation is drawn down at an annuitised rate to life expectancy. The 10th income percentile is excluded from this analysis due to low asset levels in superannuation and relatively low marginal propensity to save. The 90th percentile is excluded because their projected balance is already over the transfer balance cap, and so cannot make post-tax voluntary contributions. Contributions and earnings concessions are calculated as the difference between concessional and marginal tax rates. Government concessions are deflated by the long-term Government bond rate. Net earnings are the change in lifetime superannuation draw downs, less change in total contributions tax and total initial capital outlay. Total retirement income and components are deflated by CPI. Source: Cameo modelling undertaken for the review.

A number of submissions suggested the effect of high effective marginal tax rates on middle-income earners is a disincentive to make additional superannuation savings. Submissions suggested that the assets test taper rate discourages people from continuing to save for retirement if they hold assets close to or just above the assets test free area.[281] Submissions also suggested people rearrange their income and assets to either gain access to the Age Pension or to increase the amount of Age Pension they receive. For example, this could be achieved by reducing the amount of assessable income and assets a person holds (e.g. increasing the value of their principal residence through home renovation).

[281] Assets test free area as at March 2020. Single home owner: $263,250; couple combined home owner: $394,500; single non-home owner: $473,750; and couple combined non-home owner: $605,000.

Evidence that the Age Pension means test affects savings behaviour prior to retirement is weak. For the means test to affect savings behaviour, people need to be aware of and understand it. Survey research found that, when deciding how much to contribute to superannuation, people said tax concessions were a more important factor (22 per cent) than missing out on the Age Pension (8 per cent) (BETA, Forthcoming).

Recent studies have examined whether the assets test taper rate has an impact on how people save pre-retirement by analysing the changes to the taper rate in 2007 and 2017. In 2007, the assets test taper rate was lowered from $3 per fortnight for every $1,000 of assets above the threshold, to $1.50 per $1,000 of assets. This increased the value of assets a person could hold while remaining eligible for the Age Pension. In 2017, this policy was reversed, and the assets test returned to the previous rate of $3 per $1,000 (see *1B. Design of Australia's retirement income system*).

The literature is not conclusive on the impact of the taper rate on savings behaviour. One study suggested the 2007 change may have resulted in the people subject to a lower taper rate saving more (Whelan, et al., 2018). However, the authors noted the results could have been affected by the GFC or valuation effects. This makes it difficult to attribute the difference in wealth solely to the change in the taper rate.

More recent research did not show evidence of statistical correlation between the taper rate change and savings for the 2017 taper rate change (Cassells, et al., 2020). Although this may reflect the limited time since implementation.[282] For the 2007 taper rate change, this research found no statistical difference in the savings of people expected to be part-rate age pensioners before the taper rate change and those expected to be full-rate age pensioners. People expected to become part-rate age pensioners following the change were found to have higher savings than people not expecting to receive the Age Pension, although this result is not consistent with the theoretical predictions of how incentives from the taper rate could affect savings.[283]

If the assets test was driving savings decisions, evidence of bunching around the assets test free area would be expected. But Department of Social Services payment data from June 2019 does not show any evidence of bunching of assets around the assets test free area, for either single or coupled age pensioners.[284]

Other incentives to work or retire

The system can support retirement incomes by discouraging people from voluntarily retiring early, or by allowing them to earn income while retired. As outlined in *3E. Age of retirement*, early retirement leads to lower retirement savings and lower replacement rates.

Signals in the system, such as the age people are eligible for the Age Pension and the preservation age, strongly influence when people retire. However, other financial incentives do not seem to have much impact, either on the timing of retirement, or the likelihood of working during retirement.

Financial incentives to continue working are ineffective for those who retire involuntarily. This group could be helped by removing barriers to work; for example, by introducing measures to reduce ageism, increasing the flexibility of work and care arrangements or encouraging lifelong learning.

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[282] The Household, Income and Labour Dynamics in Australia (HILDA) Survey only collects information on wealth every four years. Cassells et al. (2020) were thus limited by access to only the latest HILDA Survey release (2018) to study the 2017 taper rate changes.

[283] A simple two-period life-cycle model as in Whelan et al (2018) would predict taper rate reduction to de-incentivise savings of this group due to the exposure to taper rate (substitution effect) and increased pension payments (income effect). This suggested a better theoretical framework and better data would be required to examine the effect of taper rate on savings behaviour.

[284] Department of Social Services analysis of 2019 payment data.

That said, for a significant proportion of people, retiring before the Age Pension eligibility age is a choice: just under 40 per cent of voluntary retirements take place between the ages of 55 and 64 (ABS, 2020n).

Financial incentives to keep working

Several policies in the retirement income system are designed to encourage older workforce participation, such as:

- **The Work Bonus**. This increases the amount an eligible age pensioner can earn from work before it affects their Age Pension rate
- **The 'Work Test' for superannuation contributions**. To satisfy the Work Test, people must work at least 40 hours during a consecutive 30-day period each financial year. The Work Test is easy to satisfy and unlikely to encourage high levels of workforce participation
- **Transition to Retirement Income Streams program**. This program aims to prolong workforce participation by allowing workers who have reached preservation age and wish to continue working to access their superannuation
- **Income tax reductions for those age 65 and over**. For example, the seniors and pensioners tax offset (see 1B*. Design of Australia's retirement income system*)

These incentives to encourage people to keep working appear to have limited impact. One study found Transition to Retirement Income Streams had small positive labour supply effects, which increased after the program's initial years (Carter, 2020). But the stronger response was from people with higher incomes. At least half of the participants seemed to be using tax minimisation strategies. This is consistent with findings on the mature age worker tax offset: a targeted earned income tax credit of up to $500 to incentivise participation of older workers, which existed from 2004-05 to 2014-15. The mature age worker tax offset increased labour market participation by around 0.5 percentage points (Breunig & Carter, 2018).

The seniors and pensioners tax offset's effectiveness in encouraging older workforce participation is unclear. The seniors and pensioners tax offset decreases effective marginal tax rates for seniors earning less than about $15,000 a year but increases them for those earning more than $20,000 a year, as benefits are withdrawn.

Some stakeholders argued the Age Pension income test creates disincentives to continue to work in retirement. A study from 1990 found evidence of age pensioner income 'bunching' below means test income thresholds (Creedy & Disney, 1990). However, these findings are inconsistent with current Age Pension payment data.[285] This shows that, of the 4 per cent of age pensioners who reported employment income in the previous fortnight, the majority had reported less than $250 in earnings.[286] This is well below the point at which employment earnings would impact an age pensioner's rate of payment.[287] As detailed above, age pensioners benefit from the Work Bonus, which allows them to keep more of the Age Pension when they have income from employment.[288]

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[285] Department of Social Services analysis of payment data.

[286] Department of Social Services payment data recipients who reported employment income in the last fortnight leading up to the reporting period: June 2015 to June 2019.

[287] Single age pensioners can earn up to $474 per fortnight from employment before their payment is reduced, due to the operation of the income test free area and the Work Bonus. See *1B. Design of Australia's retirement income system* for details.

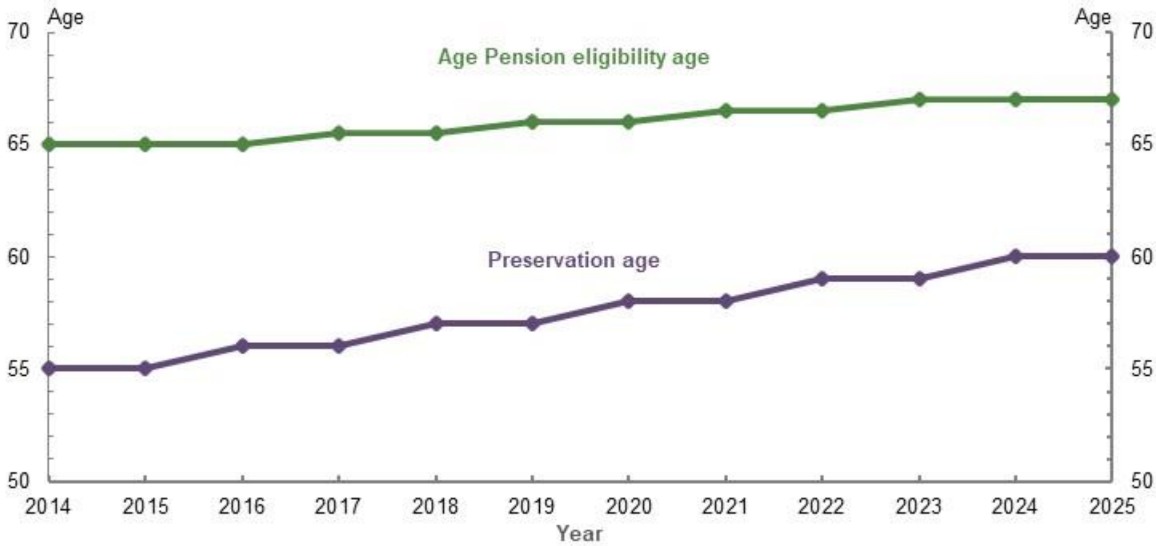
[288] See *1B. Design of Australia's retirement income system* for details on the Work Bonus.

Financial incentives to retire

Theoretically, superannuation may create an incentive for people to retire at preservation age and live on superannuation savings until they become eligible for the Age Pension. Chart 5A-6 shows the gap between the Age Pension eligibility age and superannuation preservation age. Some people may be able to offset a limited (if any) loss of income before receiving the Age Pension with a higher Age Pension in retirement (Ingles & Stewart, 2017, pp. 424-426). However, whether people are actively trying to 'game the system' by retiring before Age Pension eligibility age is difficult to assess (Agnew, 2013, p. 4).

There is little evidence that people structure their superannuation withdrawals to access the Age Pension (Productivity Commission, 2015b, pp. 91-94). One study using longitudinal data found that households above Age Pension eligibility age have more non-financial assets than households just below Age Pension eligibility age, but have similar levels of home equity (Cobb-Clark & Hildebrand, 2010). Most people do not draw down their savings. Instead, they live off the income generated by their savings (see *Current retirement outcomes*, below). People who take lump sums have low balances and do not have enough wealth to be affected by Age Pension means testing. These people were most likely to spend their lump sum on their home, including paying down mortgage debt (Productivity Commission, 2015b, pp. 83-87).

Chart 5A-6 Gap between Age Pension eligibility age and superannuation preservation age



Note: Legislated increases will occur on 1 July each year. Source: (Department of Social Services, 2020e; ATO, 2020c).

In future, when people have larger balances after 40 years of compulsory superannuation, more people may choose to retire before the age they become eligible to apply for the Age Pension. Currently, most people with large balances at retirement have saved voluntarily. These people tend to have a predisposition to save and be cautious in spending. As the SG matures, this could change.

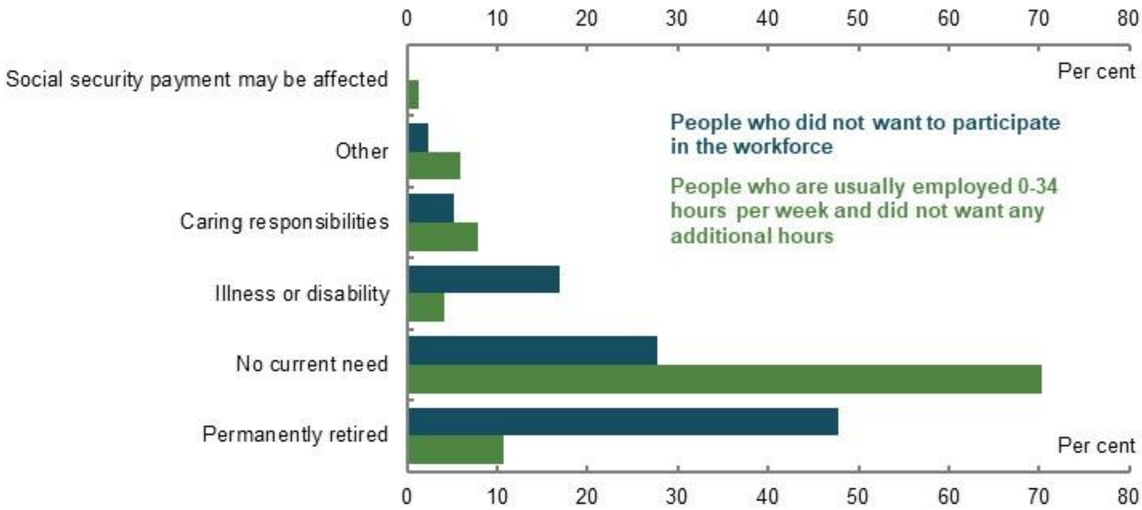
People say financial incentives do not motivate them to retire. According to Household, Income and Labour Dynamics in Australia (HILDA) data, only 4 per cent of retirees said their retirement was motivated by superannuation rules making it financially advantageous to retire.[289]

Very few people said their decision to work less, or not at all, was to avoid losing benefits such as the Age Pension (Chart 5A-7). Most people over 55 who do not want a paid job, or who work less

[289] Analysis of HILDA survey data (Wave 15). Other reasons to retire in the HILDA Survey included non-financial reasons such as own or family member's ill health, one's partner had retired or was about to retire, a desire to have more leisure time, or job-related reasons.

than 35 hours per week and do not want more hours, said this was because they had no need to or were satisfied with their current situation or were permanently retired (ABS, 2017b). Most age pensioners do not work in retirement. The proportion of age pensioners with declared earnings from employment has slightly increased from 3 per cent in 2008 to more than 4 per cent in 2019.[290]

Chart 5A-7 Barriers to workforce participation for people aged 55 and over



Note: Survey data is for 2016-17 and has been aggregated. 'Social security payment may be affected' is from 'Welfare payments/pension/allowance may be affected', 'Other' is any remaining results outside those listed in this note. 'Caring responsibilities' is 'Caring for children' and 'Caring for ill/disabled/elderly person'. 'Illness or disability' is 'Short-term sickness or injury' and 'Long-term sickness or disability'. 'No current need' is 'No need/satisfied with current arrangements/retired from full-time work (for now)'. Permanently retired' is 'Permanently retired from full-time work/will not work full-time again'.
Source: (ABS, 2017b).

Influence of eligibility ages for the Age Pension and superannuation

The Age Pension eligibility age is a strong signal or anchor for retirement. Retirement is concentrated around the age people are eligible to apply for the Age Pension but increases steadily beginning around preservation age (Chart 5A-8). An increasing minority choose to continue working at older ages.

[290] Department of Social Services analysis of payment data.

Chart 5A-8 Changes in labour force participation rate by age

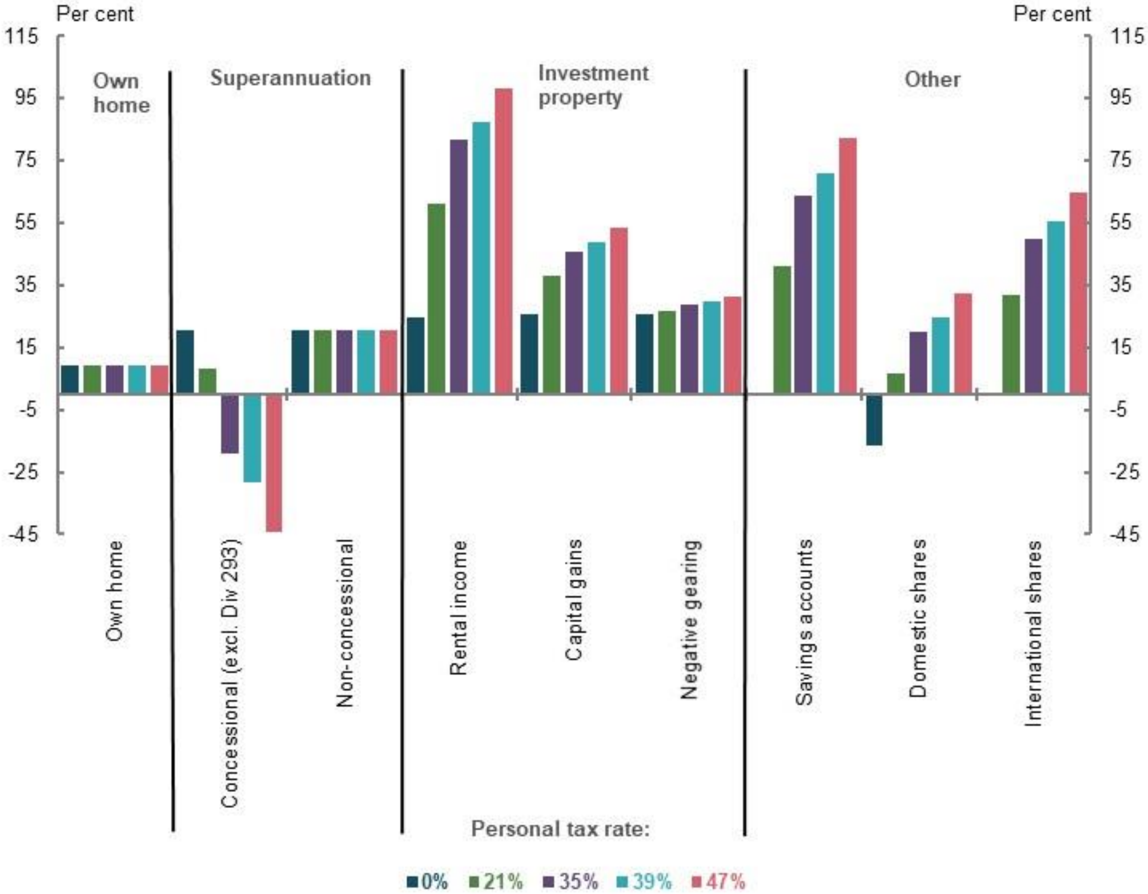
Note: This chart takes the proportion of people in the labour force at age 49, and then measures the incremental change in labour force participation rate at future ages. Source: Analysis of (ABS, 2006a; ABS, 2016a).

International evidence suggests a strong relationship between age of retirement and the ages at which social security retirement benefits become accessible (Gruber & Wise, 1997). In Australia, one study found increasing the Age Pension eligibility age by one year reduced retirement probability each year by approximately 10 per cent (Atalay & Barrett, 2012). Productivity Commission modelling showed increasing the Age Pension eligibility age from 67 to 70 increased participation rates for those at relevant ages by around 3-10 per cent (Productivity Commission, 2013a, p. 15). For further discussion on the factors that influence retirement decisions see *3E. Age of retirement.*

Incentives to invest

Incentives in the retirement income system can influence how people invest their savings and whether they maximise their investment returns. Upon retirement, most people's two largest assets are their principal residence and their superannuation (ABS, 2019k). Both have low effective marginal tax rates compared with other assets (Chart 5A-9).

Chart 5A-9 Effective marginal tax rates for different asset classes



Note: This chart shows the effective marginal tax rates in Australia for several asset types for a 20-year investment. The calculation incorporates the effects of the personal income tax including imputation credit, capital gains discounts, Medicare Levy and superannuation taxes (except Division 293 tax). It also incorporates land taxes and stamp duties. It uses a baseline where people pay the full marginal tax rate on labour income but no further taxes on savings. Concessional tax rates on superannuation and annual rental losses on negatively-geared properties reduce total tax revenue and can generate negative effective marginal tax rates. For people on 47 per cent income tax for whom Division 293 tax applies, the effective marginal tax rate of concessional superannuation contributions increases from -44 per cent to -14 per cent. Effective marginal tax rates for superannuation are sensitive to the assumed length of investment, the assumed rate of inflation, and the assumed real return on investment. The effective marginal tax rate on non-concessional superannuation contributions reflects the tax rate applying to real returns, making it higher than the 15 per cent nominal tax rate. Source: Data provided by the Tax and Transfer Policy Institute for the review, 2020.

Investments in the principal residence

The retirement income system has some influence on decisions to purchase a home through both superannuation and Age Pension policy settings.

Superannuation interacts with home ownership in two ways:

1. Superannuation and housing investments compete with each other for household savings, deterring investment in more liquid assets such as stocks or bonds. One study found having a mortgage marginally decreases the level of superannuation savings (Feng, 2018, p. 10). Another study and research commissioned by the review found the SG marginally decreases other household savings but has a positive effect on household net wealth (Ruthbah & Pham, 2020a; Connolly, 2007).

2. The First Home Super Saver Scheme (FHSSS) allows people to save money for their first home inside their superannuation fund, using the concessional tax treatment of superannuation to save faster. This incentive's effectiveness is unclear, with only

8,216 people accessing the FHSSS since its introduction in 2018. The average amount withdrawn was $12,882.[291]

Several submissions said exempting the principal residence from the Age Pension assets test creates an incentive to invest more in housing than would occur if the principal residence was in the assets test. Although little evidence exists to show the significance of this incentive (see *3C. Home ownership status*).

While the retirement income system affects incentives to invest in the principal residence, more influential drivers of investment in housing exist outside the system. These include financial incentives (e.g. capital gains tax concessions) that apply when most people make home purchase decisions, and non-financial factors (e.g. emotional security, stability and belonging) (Sheppard, et al., 2017).

Concentrating wealth in home ownership could lead to suboptimal outcomes. Historically, home ownership has generated good investment returns (CEPAR, 2019, p. 27). Housing inflation has contributed to wealth accumulation (Adkins, et al., 2019), benefiting retirees. However, owning a principal residence is not always the best investment option for retirement (Fox & Tulip, 2014; Masters & Price, 2019):

- Renters investing the equivalent of mortgage payments in other assets could be better off during periods when house prices are stable or falling.
- Retirees are often reluctant to sell their principal residence to fund retirement (see *Consumption of housing equity*, below).
- Retirees with large mortgage debt are vulnerable to negative economic shocks and more likely to cut back on spending (Price, et al., 2019) (see *2C. Maintaining standards of living in retirement*).

Given most home owners have better retirement outcomes than non-home owners, many submissions raised equity concerns about excluding the principal residence from the Age Pension assets test (see *3C. Home ownership status*).

Cohesiveness of the retirement phase

For the system to be cohesive, its retirement phase should support people in converting their savings into income. This is particularly important for superannuation given that compulsory savings and tax concessions exist to provide retirement income. Current retirement outcomes show savings are often not being used as income, with significant amounts left as unintentional bequests.

The complexity of decision-making at the point of retirement, relatively low levels of financial literacy and infrequent use of services such as financial advice contribute to many people making suboptimal decisions. People are more likely to rely on behavioural biases and rules of thumb when deciding how to spend their savings. This may lead to lower standards of living in retirement (see *Default bias and anchoring*, below).

For the retirement phase to be more effective, people need more assistance to navigate the system and get better outcomes; for example, through guided choice and system simplification.

[291] Data provided by the ATO for the review. Data collected from 1 July 2018 to 29 February 2020. Eligible voluntary personal contributions for the FHSSS releasable amount are not discernible from other personal contributions. Therefore, these figures only include the contributions that were released, not the contributions made with the intention of being used for the FHSSS.

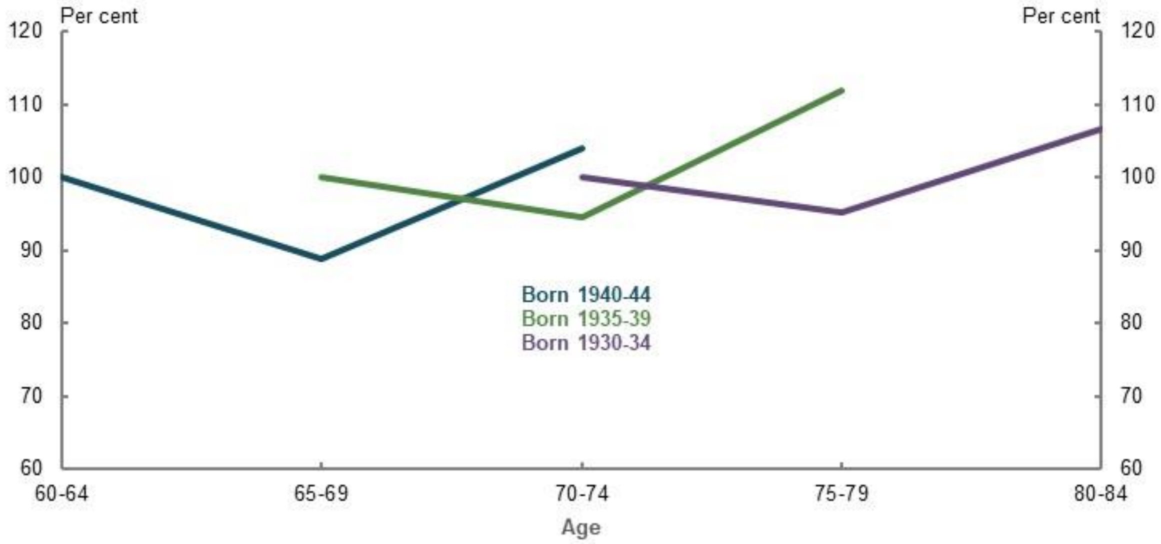
Current retirement outcomes

Consumption of assets

In general, retirees do not consume their retirement savings. Net financial wealth (including superannuation but not housing) grows in retirement, apart from a decline associated with the GFC (Chart 5A-10). For age pensioners, this is true across all asset types (including superannuation, housing and other savings), regardless of wealth levels and whether they recently started or finished their retirement (Asher, et al., 2017).[292] While this is a general trend, some age pensioners do consume more of their assets than others:

- Around 10 per cent of single age pensioners consumed 90 per cent of their assets in an eight-year period.[293] A small number of them exhausted all their assets (Asher, et al., 2017, p. 585).
- Long-term singles (those who entered retirement single) and non-home owners who receive the Age Pension tend to consume their assets faster than other households (Asher, et al., 2017, pp. 600-601).
- Younger, wealthier retirees have slightly higher rates of asset consumption, decreasing with age (Asher, et al., 2017, p. 585) (see *2C. Maintaining standards of living in retirement*).

Chart 5A-10 Household net financial wealth by age cohort, excluding the family home, relative to 2005



Note: Based on net financial wealth from the 2005-06, 2009-10 and 2015-16 iterations of the Survey of Income and Housing. Net financial wealth is total net wealth excluding the value of the principal place of residence (and related mortgage liabilities), personal effects and motor vehicles. Deflated by CPI. Source: (Daley, et al., 2018b).

As a result, when retirees die, most leave the majority of the wealth they had at retirement as a bequest (Daley, et al., 2018b, p. 32; Reeson, et al., 2016). Data provided by a large superannuation fund found members who died left 90 per cent of the balance they had at retirement. Another study found a similar result: at death, age pensioners leave around 90 per cent of the assessable assets they had at the point of retirement (Asher, et al., 2017, p. 585). This suggests that retirees tend to consume only the income derived from assets and not the assets themselves.

[292] Department of Social Services payment data.
[293] Asher et al. used a Department of Social Services random sample from 1999 to 2007.

The evidence suggests the Age Pension means test taper does not have a strong effect on people drawing down or consuming their assets. Department of Social Services administrative data shows age pensioners generally maintain their assessable assets well into their later years, with a large proportion increasing or maintaining their assets holdings.[294] This result occurred both when the assets test taper was reduced to $1.50 (from 2007 to 2016) and at its present rate of $3.

Consumer surveys and anecdotal material presented in submissions support these findings and reveal that Australian retirees are keen to preserve their savings throughout retirement.
One stakeholder noted:

> *'…retirees express concern or distress about the difficulty of living off the earnings from their retirement lump sums. The suggestion that they should be drawing down on the lump sum to improve their income is strongly resisted, even when they are of an advanced age and have a significant lump sum.'*
> *(COTA, 2020, p. 28)*

This lack of consumption of retirement assets is consistent with studies conducted in the US and the Netherlands (Ooijen, et al., 2015; Dynan, et al., 2004).

Draw down of superannuation assets

Maintenance or growth of balances in retirement occurs despite policy settings in the retirement phase that are designed to influence drawdown behaviour.

- **The Age Pension means test.** The test is designed to encourage people to use their own resources before 'calling on the Government for support' (Department of Social Services, 2015). This encourages use of assets in retirement by withdrawing support for people as their level of assets increase. Retirees affected by the assets test who draw down their superannuation and other financial assets more quickly receive increased Age Pension support over their retirement. Australia is unique in having two different Age Pension means tests: one based on assets and the other one is income (see *1B. Design of Australia's retirement income system*).
- **Superannuation drawdown rules.** Each year, people are required to withdraw a certain percentage of their superannuation, based on their age, to maintain their earnings tax exemption in retirement. The percentage that must be withdrawn each year increases with age. The purpose of these rules is to ensure that savings receiving the earnings tax exemption are used for retirement income purposes and not for estate planning purposes (The Treasury, 2016c, p. 3). The rules are not designed for people to optimise their retirement income.

The higher a person's superannuation balance, the more likely they are to draw down at the minimum rate (Chart 5A-11). Drawing down at the minimum rate is likely to leave a large balance at life expectancy (currently around 85). The Australian Government Actuary projected the nominal superannuation balance at death for someone who died at or before age 90, and drew down at the minimum rate, would be larger than their balance when starting retirement (Treasury 2016, p. 5).

People on lower balances draw down at much higher rates than those with higher balances across all ages in retirement. This is consistent with findings that most people who take a lump sum from superannuation have low balances (Productivity Commission, 2015b).

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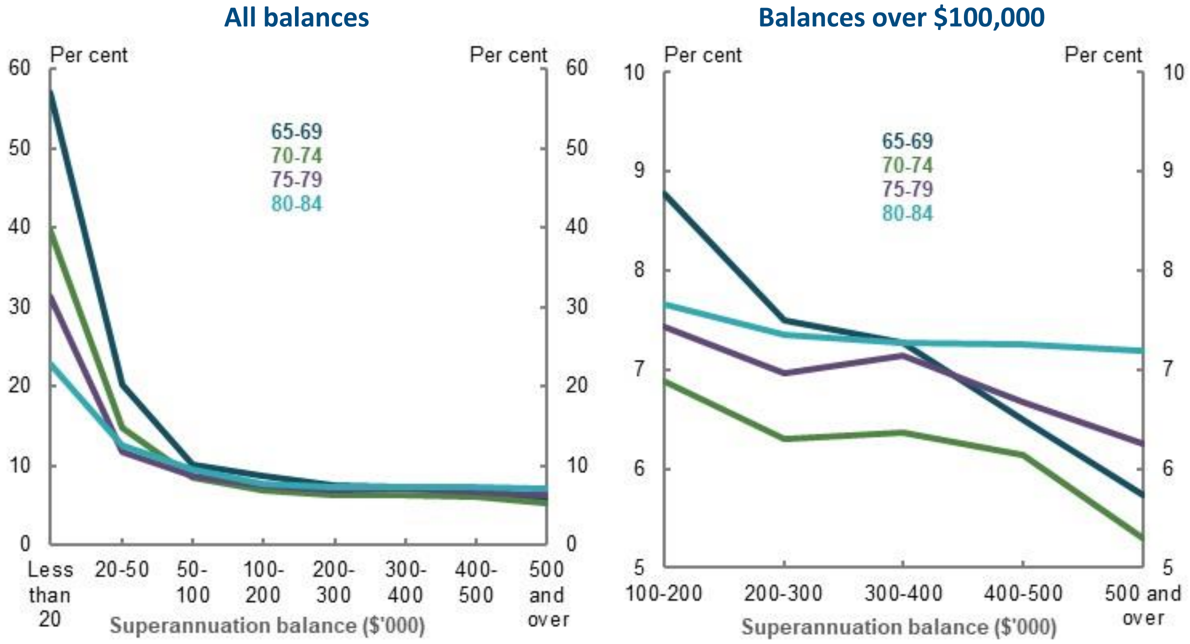
[294] Department of Social Services analysis of payment data, 31 December 2012 and 31 December 2017.

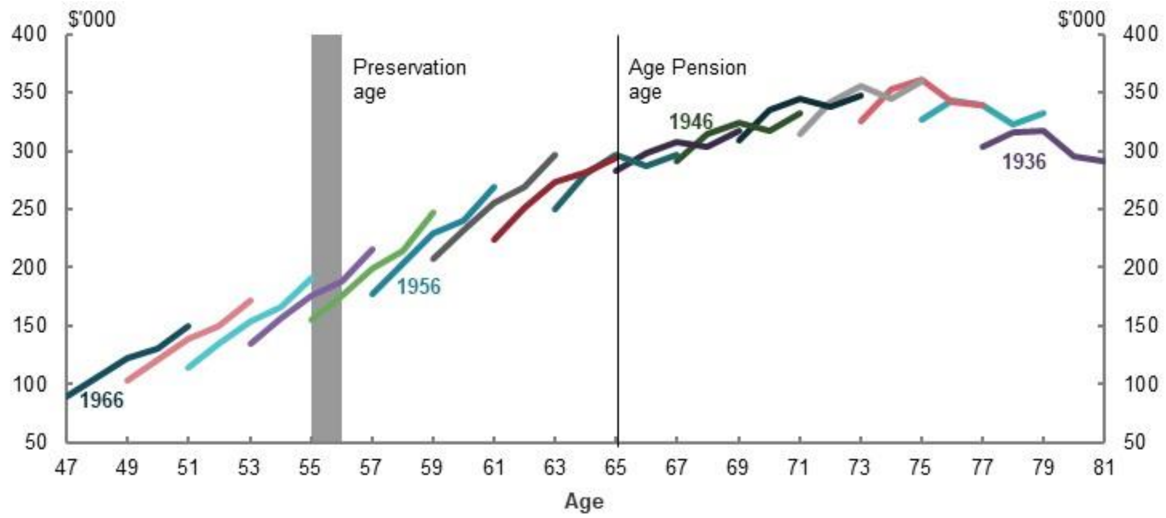
Chart 5A-11 Median superannuation drawdown rates, by age group and asset level



Source: Analysis of Rice Warner data, 2018.

Superannuation assets have tended to grow in retirement (Chart 5A-12), instead of declining as would be expected if assets were funding retirement. This means investments have tended to equal or exceed drawdown rates.

Chart 5A-12 Average superannuation balances, by age cohort



Note: Values are in 2017 dollars deflated by CPI. ALife data, 10 per cent sample. Data for 2013 to 2017, members with balances above zero dollars at 30 June 2013. Includes every second one-year birth cohort born 1936-66. Source: (Polidano, et al., 2020).

While the tax data shows a drop in the average superannuation balances of people in the oldest cohort born in 1936 (Chart 5A-12),[295] Department of Social Services analysis of payment data relating

[295] This group represents a very small portion of the retiree population: approximately 0.1 per cent of the population of those with superannuation balances were born in 1936. Analysis of Survey of Income and Housing 2017-18.

to age pensioners does not show any significant change in assessable assets in the five years before death.[296]

Low consumption of superannuation precludes higher living standards. People could have a higher standard of living, either in retirement (by consuming more) or during their working lives (by saving less).

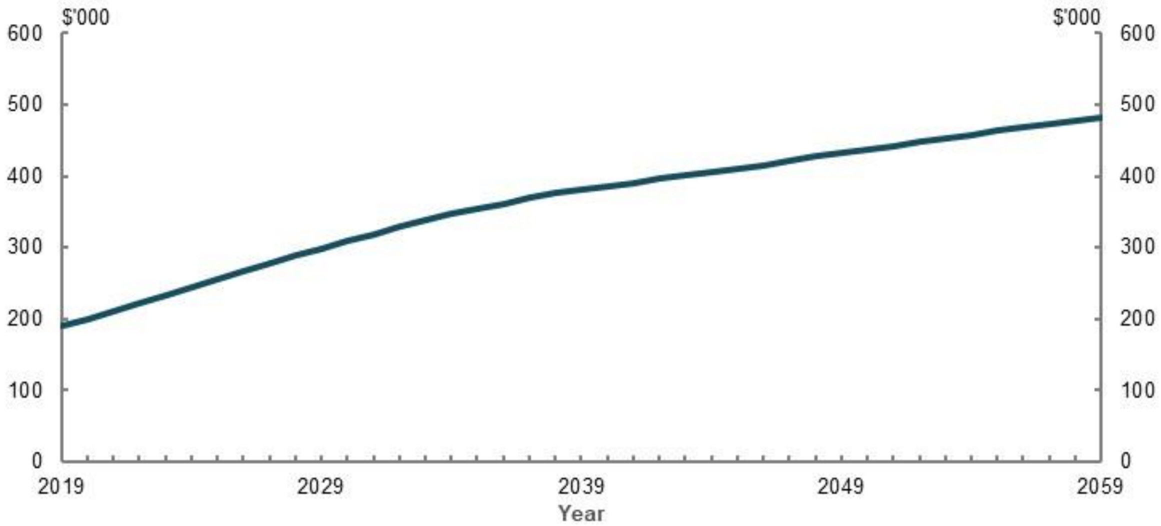
Reflecting the retirement income system's intent to generate income for retirement, most adequacy analysis assumes superannuation assets are used in full or large part in retirement (Australia's Future Tax System Review, 2009, p. 68; Dawkins, 1992; Grattan Institute, 2020; Rice Warner, 2019c; The Treasury, 2002)

If superannuation was consumed more efficiently in retirement, most people would have higher replacement rates. The median earner's replacement rate is up to 19 percentage points higher if they consume their superannuation assets in retirement, relative to drawing down at minimum rates (see Chart 2C-18 in *2C. Maintaining standards of living in retirement*).

Drawing down and consuming assets is the most effective way for people to achieve adequate retirement incomes. It is especially important during periods of significant economic shocks and financial market volatility, such as the COVID-19 Pandemic. With ultra-low interest rates and reduced dividend payments, returns alone cannot be expected to generate sufficient income; retirees will need to draw down savings. Drawing down must be combined with strategies to effectively manage investment and sequencing risks (see *2C. Maintaining standards of living in retirement*).

Without a change to retirees' drawdown behaviour, bequests from superannuation will grow. Rice Warner projections show average death benefits from superannuation for people aged 65 and over are expected to grow in real terms from an average of $190,000 in 2019 to more than $480,000 by 2059 (Chart 5A-13). Aggregate death benefits are projected to increase from around $1 of every $5 paid from the superannuation system in 2019 to around $1 of every $3 paid out by 2059. Bequests from housing assets will also increase if housing assets continue to grow and retirees avoid drawing on their housing wealth.

Chart 5A-13 Projected average superannuation death benefits for population aged 65 and over



Note: Values are in 2019 dollars, deflated by CPI. Source: Analysis of Rice Warner estimates for the review.

[296] Department of Social Services analysis of payment data, 31 December 2012 to 31 December 2017. Captures people who died in 2018.

Box 5A-4 Bequests and low consumption in retirement

Bequests do not appear to be a high priority for retirees. Despite the significant number of bequests, several surveys found 'leaving a bequest' is one of the least important retirement savings objectives for people (National Seniors Australia and Challenger, 2017; Alonso-Garcia, et al., Forthcoming; Hobman & Reeson, Forthcoming; Mercer, 2019a). One study found bequests ranked 18 out of 19 possible savings motives in retirement (Alonso-Garcia, et al., Forthcoming, p. 27). Similarly, bequests ranked last out of nine possible attributes for savings in a consumer group survey (National Seniors Australia and Challenger, 2017, p. 9). They ranked among the bottom three desired retirement income product features in another survey (Mercer, 2019a, p. 4).

The bequest motive may be different for the principal residence. Some researchers suggested the principal residence serves a dual purpose: allowing people to fund out-of-pocket aged care and health expenses as needed and, if not needed, leaving a bequest (CEPAR, 2019). In a Productivity Commission survey (2015a, p. 14), 71 per cent of respondents said they saw the family home as a safety net for adverse events, and 44 per cent said they wished to pass the family home on to their children.

Consumption of housing equity

Retirees tend to avoid using housing wealth to fund their retirement, despite it being their largest store of wealth (Whelan, et al., 2019). Yet, research shows Australians are increasingly likely to borrow against the value of their home for other purposes, such as purchasing investment property (Ong, et al., 2019).

The Government has two programs to encourage the use of housing equity to fund living costs in retirement (see *1B. Design of Australia's retirement income system*).

- **Pension Loans Scheme**. Take-up of this scheme, while increasing, remains low (Table 5A-2). Some stakeholders suggested the name of the scheme and the way eligibility for the scheme is described undermine take-up, as non-pensioners may not understand they are eligible.
- **Downsizer contribution scheme**. Between 1 July 2018 and 17 January 2020, more than 9,000 people made downsizer contributions, with an average contribution of $230,000.[297]

The existence of many 'asset rich, income poor' retirees on the Age Pension suggests home equity release has significant potential to help support retirement incomes (see *3C. Home ownership status*).

Table 5A-2 Use of the Pension Loans Scheme

	June 2018	March 2020
Participants	642	2,288
Number of new loans	80 (six months prior)	1,500 (nine months prior)
Average debt	$45,366	$18,884
Largest debt in scheme	$345,863	$423,250

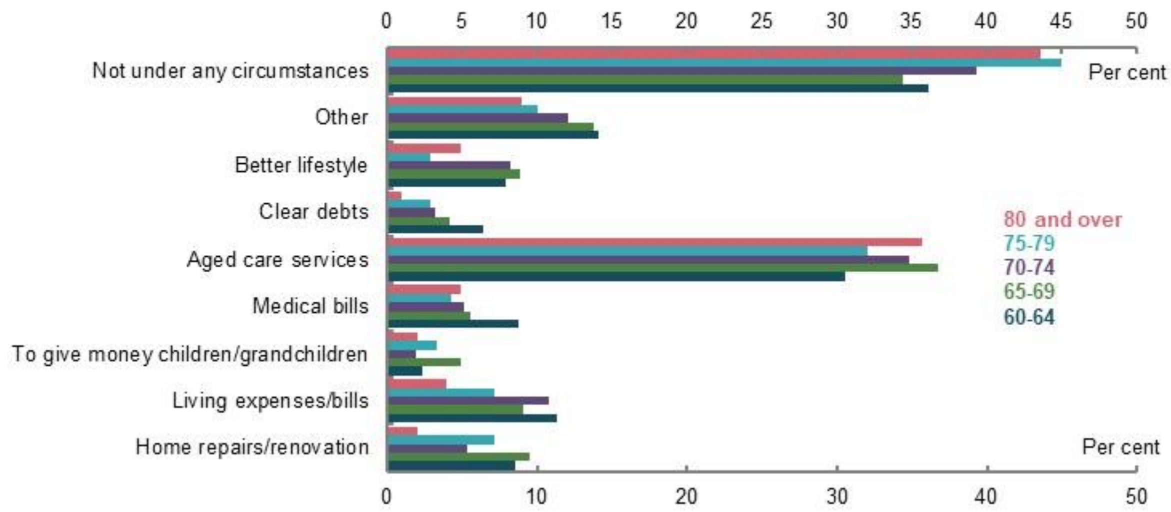
Source: Department of Social Services payment data.

Despite these Government initiatives, and the potential benefits of equity release products (Box 5A-5) especially for retirees who are asset rich and income poor, retirees still tend to draw less on home equity than other assets. This is because they:

[297] Data provided by the ATO for the review.

- Want to use their home equity to fund future expenses such as aged care services (Chart 5A-14) (Productivity Commission, 2015a)
- View mortgage equity products as inherently risky (Ong, et al., 2013, p. 2) and do not understand the nature of Government programs such as the Pension Loans Scheme (Davis, 2020)[298]
- Wish to 'age in place', lack suitable downsizing options or want to pass on their principal residence to heirs (CEPAR, 2019; Productivity Commission, 2015a, pp. 68-69)
- Are put off by transaction costs, such as stamp duty, and the difficulty of moving (Productivity Commission, 2015a)

Chart 5A-14 Circumstances in which retirees would draw down the equity in their home, by age



Source: (Productivity Commission, 2015a, p. 58).

Box 5A-5 The home equity release market

Retirees can access the equity stored in their home by downsizing or through different types of equity release products,[299] including:

- **Reverse mortgages**. The most common equity release product, where the capital accessed and accumulated interest are paid back when the owner sells the home (Productivity Commission, 2015a)
- **Home reversion**. Where a retiree sells a proportion of the future value of their principal residence while they continue to live there. The share is sold for a discounted portion of the market value. The household receives a lump sum and keeps the remaining proportion of the home equity (Moneysmart, 2020)

Home equity loans. This is essentially a mortgage. Traditional home equity loans have a repayment term, just like regular conventional mortgages. People make regular, fixed payments covering both principal and interest. As with any mortgage, if the loan is not paid off, the property could be sold to satisfy the remaining debt

[298] In his submission to the review, Davis (2020) noted households generally do not understand there are no repayment obligations under the Pension Loans Scheme until the property is sold and suggested it would be more attractive to retirees if presented as cash outflows associated with repayment of a loan rather than 'pension and loan payments'.
[299] For more information on different products available see https://moneysmart.gov.au/retirement-income/reverse-mortgage-and-home-equity-release.

Table 5A-3 Factors constraining Australia's home equity release market

Demand factors	Supply factors
The value of the principal residence is excluded from the Age Pension means test. If accessing the equity released in the principal residence affects a retiree's Age Pension eligibility, this option is less attractive than drawing on other assets.	Lenders have high barriers to entry, including capital adequacy regulations, difficulties in obtaining wholesale funding and low interest rates squeezing profit margins (ASIC, 2018c, p. 53).
People generally have negative perceptions about home equity release products, believing they take advantage of vulnerable people or contribute to elder abuse (ASIC, 2018c).	Anecdotal evidence suggests potential providers are concerned about reputational risks if retirees release equity in their principal residence without informing beneficiaries.

The private market for home equity release is still relatively small compared to the 1.9 million home-owning households aged over 65 in 2017-18 (ABS, 2019n). At the end of 2014, reverse mortgages totalled around 40,000 (Productivity Commission, 2015a). Anecdotal evidence suggests the market may have since dropped to less than 30,000.[300] Australia has a limited number of reverse mortgage providers, with just two writing 80 per cent of new loans from 2013-2017 (ASIC, 2018c). Other private equity release products are available, including debt-free products such as fractional property investment, but these have even smaller take-up.

Other countries have seen stronger growth in the equity release market. In particular, the UK had rapid growth in equity release products across all regions (Equity Release Council, 2019), albeit off a low base. Market innovation has played a role in this development (Rozario, 2012), as well as policy initiatives. For example, in the UK an inheritance tax of 40 per cent of the value of an estate worth more than £325,000 (more than A$550,000) may encourage capital draw down.

Risk and uncertainty

Low consumption of assets in retirement is partly the result of people insuring themselves against risk and protecting themselves from uncertainty. Retirement involves complex risks and uncertainties, which people often struggle to understand:

- **Market risk**, including the risk of negative returns.
- **Longevity risk**. The risk of running outliving one's savings, which tends to increase if returns are invested conservatively to manage market risk.
- **Inflation risk**. The risk of living expenses increasing more than expected.
- **Sequencing risk**. The risk of converting assets to income during an economic shock, like the GFC or the COVID-19 Pandemic.

Choosing a suitable retirement income product and drawdown pattern involves understanding and trading off these risks, as well as future and present consumption. This sort of complex risk calculation is normally done by actuaries, who are trained in understanding and calculating complex risks. Many people overestimate their likely future spending on health and aged care because they do not know or understand the value of in-kind support the Government provides for these services (see *4. Sustainability*).

Longevity risk

Retirees want to be debt-free and feel financially secure in retirement (Orford Initiative, 2019).

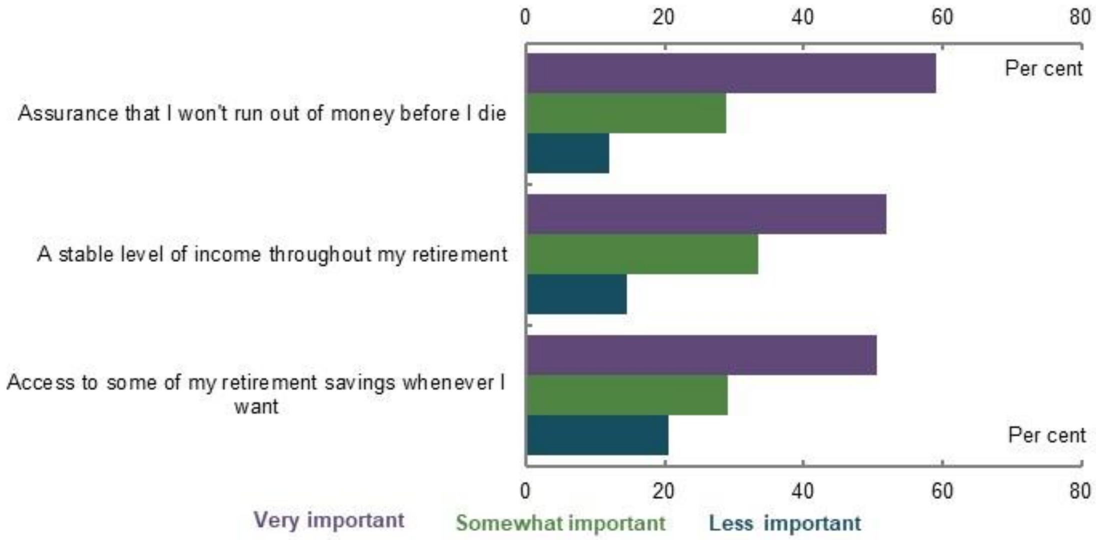
Many retirees are concerned they will run out of money before death (Rees, et al., 2018), even though most die with a substantial proportion of their wealth intact. This could be because people

[300] Department of Social Services.

misunderstand how compounding affects savings growth (savings invested in superannuation do not grow linearly, but exponentially) and do not take into account earnings when they consider their savings (McKenzie & Liersch, 2011). Emphasising that the Age Pension protects people from longevity risk could help to ease some of these concerns. However, many retirees are also concerned about the stability of Age Pension settings (see *Uncertainty and precautionary savings*, below).

Income streams that provide longevity risk management can be funded publicly (the Age Pension) or privately (annuitised products or defined benefit pensions). People aged 55 and over say they value longevity risk management features in retirement income products more than other retirement income product features (Chart 5A-15), but they generally do not invest in products that have these features.

Chart 5A-15 Importance of retirement income product features



Note: More than 1,000 survey respondents aged 55 and over. Source: (Mercer, 2019a, p. 3).

At June 2019, around 83 per cent of accounts in the pension phase were invested in account-based pensions that do not manage the risk of running out of money in retirement.[301] Most of the remaining assets are invested in term annuities, which only provide a guaranteed income stream for a limited period and therefore do not manage longevity risk beyond the term of the product.

Retirees may be self-insuring against longevity risk and only consuming the minimum necessary in order to avoid running out of savings (Financial System Inquiry, 2014, p. 120). Explanations for this behaviour include the current framing of annuities and their complexity, perceived lack of value for money, and the role of the Age Pension in providing a constant income stream (see Box 5A-15). Other contributing factors are the role of funds in only offering account-based pensions, as well as the incentives for financial advisers to recommend products that require regular monitoring and subsequent financial advice.

Longevity risk protection should encourage people to consume their other assets. However, evidence from the US suggests even people with guaranteed, constant income streams are unlikely to draw down their non-pension assets to generate income. Evidence from the US shows defined benefit recipients consume less of their non-pension assets than other retirees (Banerjee, 2018).

These findings suggest retirees are still reluctant to draw down their assets, even if they have a high degree of longevity risk protection. It appears retirees may be influenced by a desire not to spend

[301] Calculations using (Australian Prudential Regulation Authority, 2020a).

their assets (asset-framing bias). Concern about outliving savings is unlikely the sole driver of current drawdown behaviour.

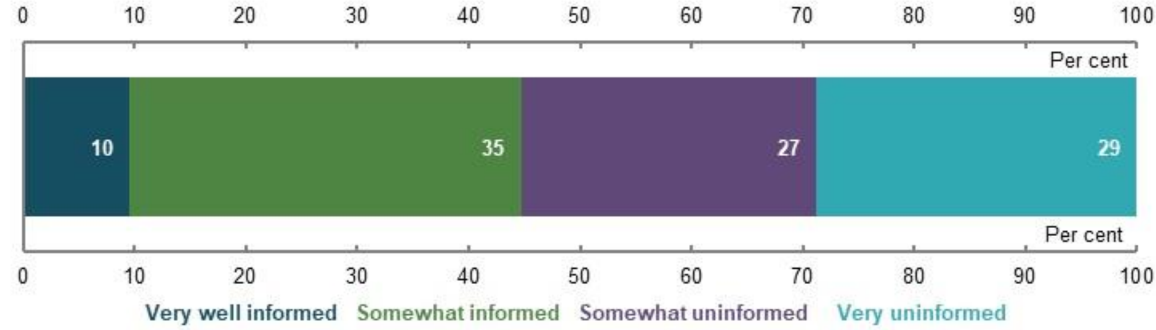
Uncertainty and precautionary saving

Retirees may also be managing the risk of the need to fund lump-sum expenditure by avoiding drawing on their retirement savings. Some academic literature and submissions suggest fears around aged care costs could hold retirees back from drawing down on their assets in retirement (Daley, et al., 2018b; Productivity Commission, 2015a; Actuaries Institute, 2019, p. 31; CEPAR, 2019; Asher, et al., 2017, p. 595). Retirees are more likely to draw down their savings in countries with greater public coverage of aged care and health care, than in countries like Australia, where retirees fund some of their own aged care costs (Daley, et al., 2018b, p. 33). However, it is unclear whether there is a causal link, or whether the difference in behaviour is a result of cultural or attitudinal factors, such as different attitudes towards relying on social security in different countries.

Health and aged care costs are heavily subsidised in Australia. Most people's expenditure on these items does not increase significantly during retirement (see *Appendix 6A. Detailed modelling methods and assumptions* and *4. Sustainability).* But households may not be aware of the extent of Government subsidies, especially given the complexity of aged care means-testing arrangements (Box 5A-6). Researchers have argued that many retirees do not realise the value of the aged care safety net (CEPAR, 2019, p. 34).

In contrast, aged care literacy and concern about aged care are low (Mercer, 2019a; Rees, et al., 2018; Aged Care Financing Authority, 2018, p. 35) (Chart 5A-16) and many people may not consider aged care costs when deciding whether to draw down their assets. Surveys suggest many people are not interested in finding out more to help them plan for retirement and would prefer not to think about aged care (Aged Care Financing Authority, 2018, pp. 32-33; McCallum, et al., 2019, p. 23). Another survey found only 25 per cent of respondents were concerned about covering aged care costs (Mercer, 2019a). This remained consistent even as people aged.

Chart 5A-16 How informed people feel they are about aged care costs and the steps involved



Note: Respondents aged over 40. Source: Investment Trends October 2019 Retirement Income Report.

People's confidence in their ability to fund aged care costs appears to be linked to household income and home ownership. Households with incomes above $50,000 were more likely than those with lower incomes to have confidence in their ability to pay aged care costs (Aged Care Financing Authority, 2018, p. 34). Home owners without a mortgage were more confident than those with a mortgage or renting (Aged Care Financing Authority, 2018, p. 34).

A National Seniors survey found that, for those who had considered how to fund aged care, their principal residence was the main source of funding (McCallum, et al., 2019, p. 23). However, only a minority of retirees said they would consider drawing on the principal residence for aged care or health expenses (Productivity Commission, 2015a). Aged care costs were the most reported reason a person would draw down home equity (almost 40 per cent) (Chart 5A-14). However, the same proportion said they would not draw down under any circumstances. Some retirees may sell the principal residence to pay a Refundable Accommodation Deposit (or RAD) and/or to fund their aged care expenses (Box 5A-7).

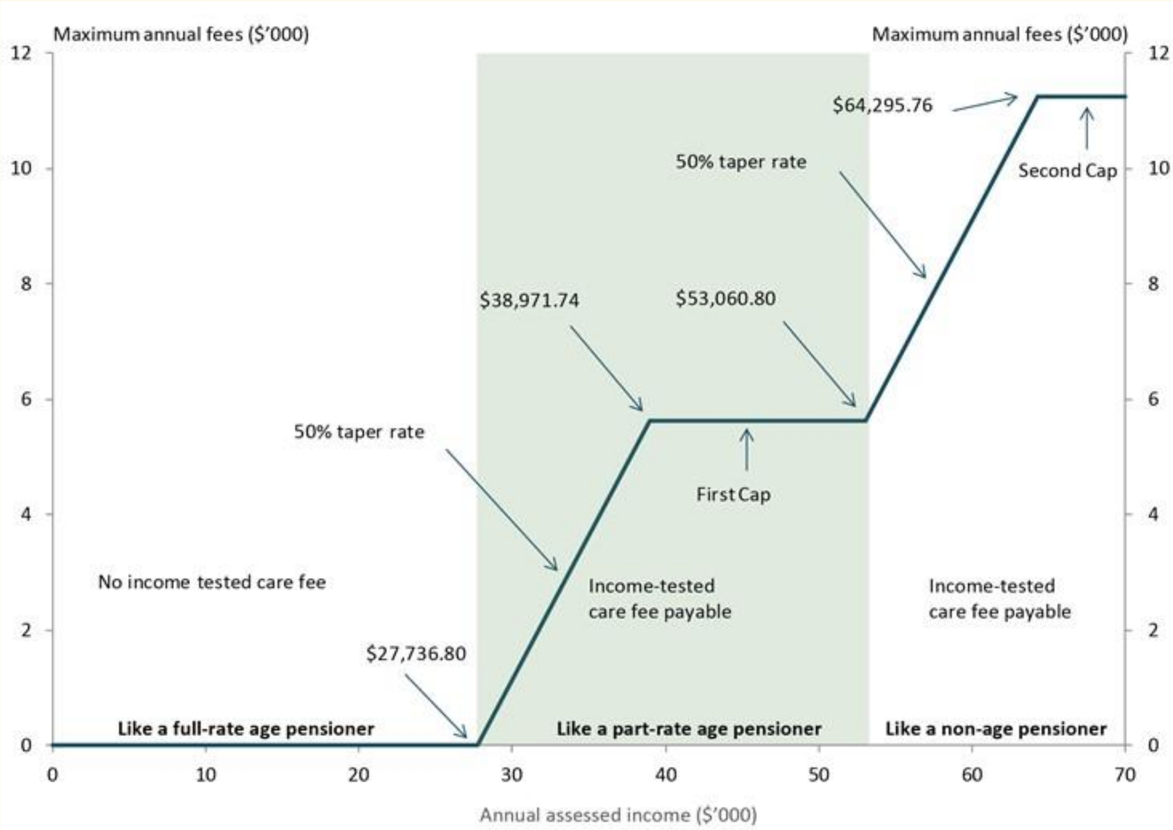
While aged care costs might explain some of the reticence to draw down on housing assets, it is unlikely to be a major driver of the low draw down of superannuation assets.

Box 5A-6 Aged care — types and means testing

Aged care services and costs depend on the care type retirees choose:[302]

- **Commonwealth Home Support Program**. Provides low-level support at home. Services include access to nursing, meals, home modification and transport. Care is not formally means tested. People may pay a co-contribution payment, which varies based on the services required and the fees set by providers.
- **Home Care Packages**. Provides higher-level home support for those with more complex care needs. Four levels of packages are available based on the person's care needs. Most people pay a basic daily fee, depending on their package level ($9.63 to $10.75 per day). Some are required to pay an income-tested care fee of up to $30.86 per day (Chart 5A-17).

Chart 5A-17 Income test for home care

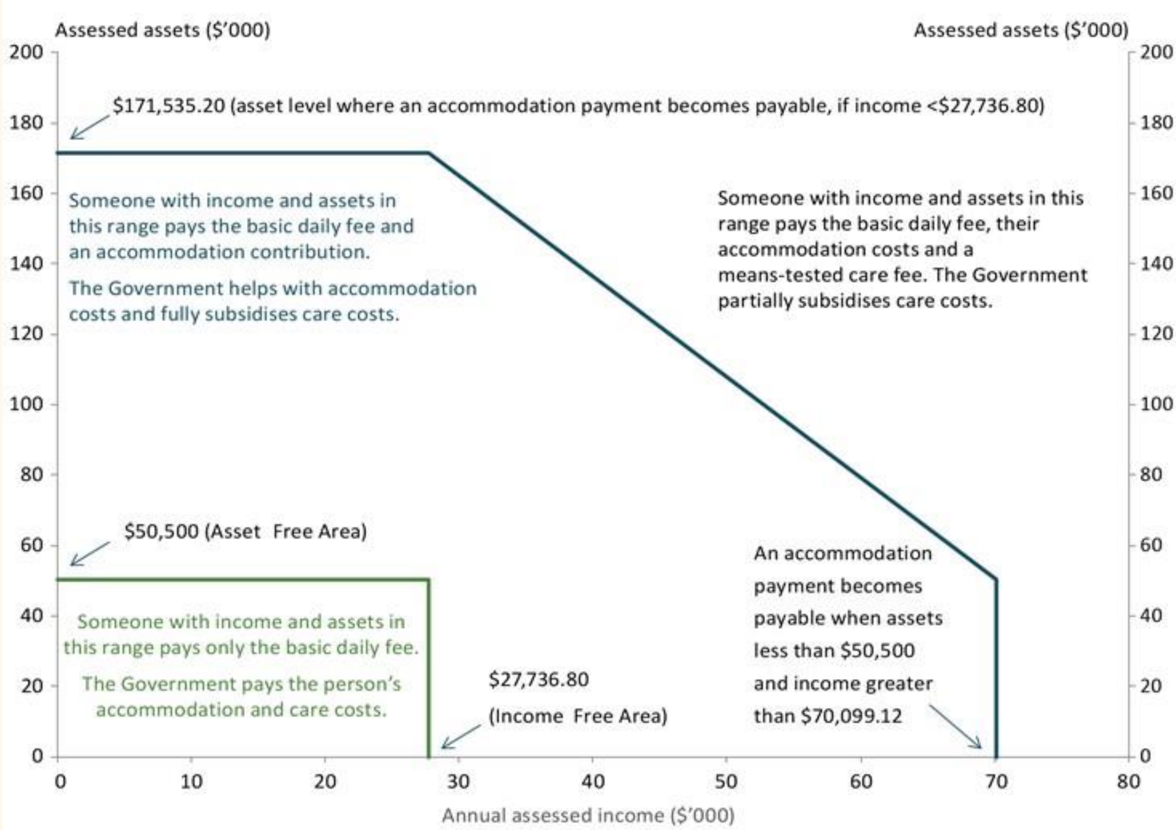


Source: Department of Health.

- **Residential care**. Provides full-time care and accommodation for people who are no longer able to live independently in their home. All residents pay the basic daily fee (set at 85 per cent of the single base rate of Age Pension) to cover daily living costs, such as meals, cleaning and laundry. People may also pay a means-tested care fee and/or fully or partly cover their accommodation costs (see Chart 5A-18). Many residential facilities also offer optional 'extra' or 'additional' services at a cost to the resident.

[302] All fees and caps correct as at 1 May 2020.

Chart 5A-18 Means test (assets and income) for residential care



Source: Department of Health.

To assess assets for means-tested care fees, the value of the principal residence is capped under the means test unless the property is:

- Occupied by a protected person (a partner, dependent child or eligible carer living in the home with the resident for at least two years), in which case the value is not included at all
- Sold, at which point the full value is included

Table 5A-4 Means testing of residential aged care

Annual income ($)	Assets ($)	Area in diagram above	Basic daily fee ($)	Means-tested care fee ($)	Accommodation payment
Below 27,840	Below 50,500	Inside green box	52.25	Nil	Nil
27,840 to 70,320 (50% taper)	50,500 to 171,535.20 (50% taper)	Outside green box, inside blue line	52.25	Nil	Partial payment (Government subsidy available)
70,320 and above	171,535.20 and above	Outside blue line	52.25	Up to 259.15, up to an annual cap of 28,087.41 per year or lifetime cap of 67,409.85 home and residential care combined	Full cost payable

Source: (Department of Health, 2020a).

Fee caps

Annual ($28,087.41) and lifetime ($67,409.85) caps on combined means-tested care fees in home and residential care currently protect those who may require aged care services for long periods of time, from very high costs. These caps are a form of social insurance. Both the Aged Care Financing Authority and the *Legislated Review of Aged Care 2017* recommended the caps be removed (Aged Care Financing Authority, 2019; Tune, 2017).

Currently, only a small number of people (1.8 per cent of people in residential care, 2018-19) reach the annual cap, and even fewer reach the lifetime cap (0.8 per cent of people in home and residential care in 2018-19).[303]

Box 5A-7 Using retirement income and assets to cover aged care costs

The costs associated with residential care accommodation can be paid as a refundable lump-sum deposit (RAD), as a non-refundable ongoing Daily Accommodation Payment (DAP) or a combination of both. Residential aged care providers often prefer RADs because they can be used for capital financing. But providers can no longer *require* consumers to pay a RAD. Increasingly, people are choosing to pay their accommodation fees daily, rather than as a lump sum (Aged Care Financing Authority, 2019). In 2017-18, 73 per cent of the aged care population paid their accommodation fees by either a DAP or a combination of the DAP and RAD (Aged Care Financing Authority, 2019, p. 120).

People have a range of options for funding aged care, depending on their total means and how their assets are invested. Stakeholders considered equity release and private insurance were underutilised options that are likely to be more efficient than precautionary saving. Some academics are currently exploring the viability of long-term care insurance in Australia (National Seniors Australia, 2020; CEPAR, 2019, p. 32).

If people are able to meet all their aged care costs using regular payments, having a steady income stream may give them a greater degree of comfort that they can meet these costs. Private income streams can be created by drawing down financial assets (such as superannuation), using housing assets through equity release, or (if available) purchasing long-term care insurance.

However, most people in home and residential care are full-rate Age Pension recipients. In June 2016, 82 per cent of people in home care and 60 per cent of new residential care admissions were full-rate Age Pension recipients (Tune, 2017, p. 160). As the superannuation system matures and people retire with more savings, future generations may be better able to contribute to their aged care costs.

Complexity and defaults

As well as the risks and uncertainty already discussed, retirement involves multiple decisions and difficult trade-offs. At retirement, people face decisions around:

- When to retire
- Whether to keep their money in the superannuation system
- How to invest their savings
- How to draw down their savings
- Their future need to meet any lumpy expenditure

Retirees have very little opportunity to learn from past experience when making these decisions, and it may be some time for the consequences of decisions to be realised. This makes it almost

[303] Data provided by the Department of Health for the review.

impossible for retirees to determine an optimal retirement income strategy on their own (Box 5A-8). Very few people seek help when making decisions (see *Improving outcomes*, below).

Interactions with other systems make the retirement income system more complex. The retirement income system interacts with many other different systems and rules in complicated ways, including:

- **The aged care system**. Home support, home care and residential care each have a different means test, which is different again from the Age Pension means test (Box 5A-6)
- **Housing**. People may need to navigate the Age Pension means test, the Pension Loans Scheme and the downsizer contribution in addition to tax rules such as stamp duty, capital gains tax, land tax and other housing rules
- **Tax rules**. Many different tax rules apply, such as to Transition to Retirement Income Streams, offsets and rebates, contributions caps, different Medicare Levy thresholds and the tax-free parts of bona-fide redundancy and approved early retirement scheme payment limits.
- **The social security system**, including Commonwealth Rent Assistance, FTB, Mobility Allowance, Remote Area Allowance and concession cards.

Box 5A-8 Complexity leads to misunderstandings and misconceptions

The views below represent perspectives observed in press articles, surveys and some submissions. These concerns are real and affect how people behave. However, they are generally not supported by evidence.

Adequacy of retirement income/retirement expenditure needs

- 'I need to preserve my assets in case I get sick or need aged care.'
- 'I will need to pay for most of my health costs in retirement.'
- 'I need $1,000,000 in superannuation for an adequate retirement income.'

Retirement income products and investment strategies

- 'The best investment strategy in retirement is very low risk, such as cash.'
- 'Investing in real estate is a better investment strategy for retirement.'

Age Pension

- 'The Age Pension is earned during working life. Taxpayers "pre-pay" for it through their taxes.'
- 'The Age Pension will become unaffordable. Most people in the future won't receive it.'

Superannuation

- 'The minimum drawdown rate is what the Government recommends.'
- 'If I withdraw my money from superannuation, I must spend it.'
- 'I should only draw down the income earned on my assets — not the capital.'

In complex situations, people get cognitive or choice overload and disengage or rely on shortcuts to help them make decisions, instead of assessing the options to make the best decision (Productivity Commission, 2018a). In complex situations people tend to:

- Rely on heuristics (rules of thumb) and pick options they understand (Benartzi & Thaler, 2007)
- Stick with what they know
- Stick with the default option
- Follow others

- Procrastinate, disengage or avoid making the decision[304]
- Be prone to misleading advice (Reeson & Dunstall, 2009)

At retirement, in the face of complexity, people fall back on defaults, even if these defaults were not designed for the purpose people use them. For example, many people rely on 'easy' options such as selecting an account-based pension and withdrawing at minimum draw down rates, or withdrawing their superannuation and placing it in a bank account. Selecting a good option involves time, money and effort, and requires giving retirees more support. The behavioural biases particularly relevant to current decision-making in retirement are default bias, anchoring and asset or 'nest egg' framing.

Default bias and anchoring

Many decisions in retirement are explained by defaults and people's reliance on rules of thumb (Bateman, et al., 2017). Research indicates retirees are strongly influenced by the statutory minimum drawdown rules:

- When people were told about minimum drawdown rates, they reduced their intended draw down from superannuation (Hobman & Reeson, Forthcoming).[305]
- People were willing to change their spending to match minimum drawdown rates (Alonso-Garcia, et al., 2017). This is consistent with research showing decisions at retirement are influenced by defaults (Bateman, et al., 2017).
- More than half of retirees older than 65 draw down at the minimum rate (Rice Warner, 2019b), and the median withdrawal amount for all ages is just above the minimum. At age 60, drawdowns bunch around the minimum and maximum amounts (Balnozan, 2018).
- One large superannuation fund reported around half of its members on an income stream chose a fixed nominal amount above the minimum, while the other half selected the minimum drawdown amount. Studies using APRA data found a similar pattern (Balnozan, 2018).

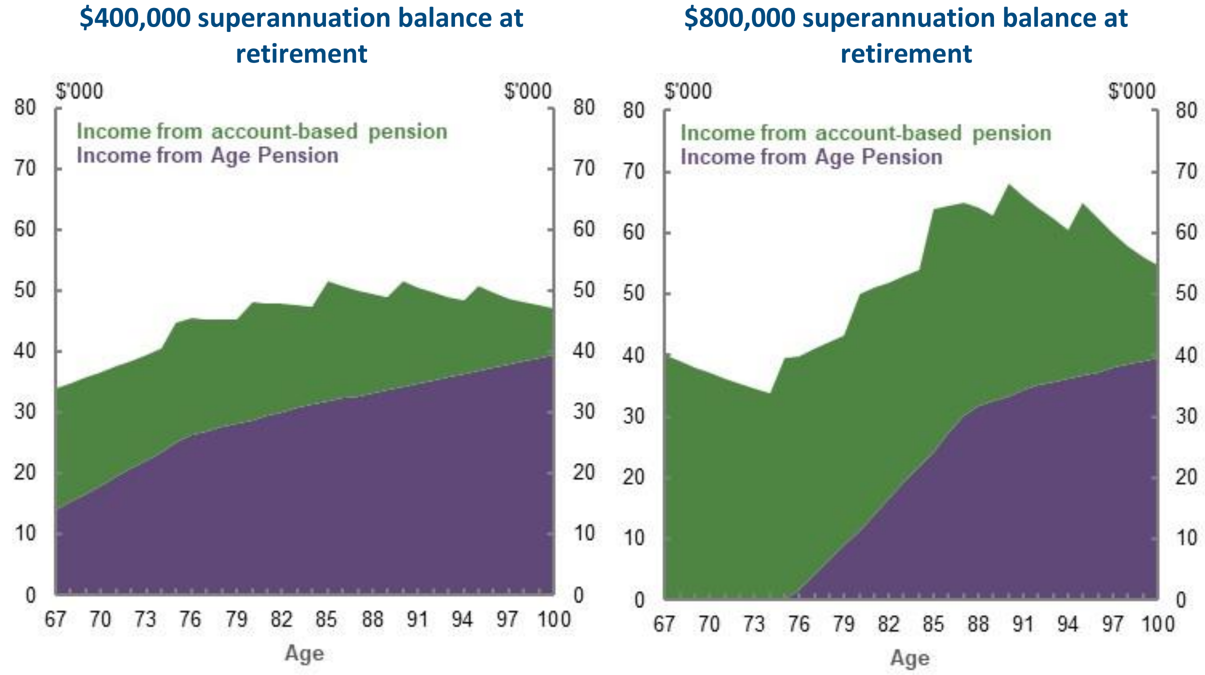
This suggests the minimum draw down rules may be acting as a 'default' option for many people when they select a draw down amount. For some, it is the easiest option to pick. For others, it is an 'anchor'; a reference point that informs their final decision on a draw down amount. The exception is the significant majority of people with low balances who withdraw larger amounts than the minimum (Chart 5A-11).

In addition to the difficulty of managing complex risks and uncertainties, most households need to combine multiple income sources to generate their retirement income. A typical retiree couple household combines at least four different income sources: the Age Pension, two superannuation accounts and assets outside of superannuation. Evidence suggests people prefer to have a stable income stream in retirement (Mercer, 2019a). To plan a stable income, people need to consider and integrate all income sources.

Current default settings in retirement contribute to income instability. The Age Pension means test, when coupled with minimum superannuation draw down requirements, does not lead to stable income for those affected by the assets test (Chart 5A-19). The income it delivers also tends to peak relatively late in retirement, at ages 85-90. This does not align with observed patterns of retiree consumption, which decline through retirement (see *Appendix 6A. Detailed modelling methods and assumptions*).

[304] Complex information makes it harder for people to react to bad outcomes, such as high fees (Thorp, et al., 2018). A large fund found some of its retired members are keeping assets in accumulation, despite the tax penalty. Willis (2017) argued some financial institutions deliberately design complex products to promote disengagement.
[305] However, people did not reduce their intended draw down when researchers focused them on the value of precautionary savings, or presented them with a scenario where people with children could leave a bequest.

Chart 5A-19 Annual retirement income if an account-based pension is drawn down at minimum drawdown rates, single home owner



Source: Cameo modelling undertaken for the review.

'Nest egg' framing

People are primed to save for retirement during their working lives, such as through compulsory superannuation. But, when they retire, they struggle with the concept that their savings are meant to be consumed to fund their retirement (Banerjee, 2015; Reeson, et al., 2016). People are primed to consider their savings are for saving, and not for spending. This 'savings mindset' is reinforced by the fact that superannuation is often described as a savings balance or even a 'nest egg', instead of in income terms (e.g. $500 a week). Evidence from the US suggests retirees are more reluctant to spend savings that they see as lump sums or investments, rather than as an income stream (Brown, et al., 2008; Madamba & Utkus, 2016).[306] Comments from an Australian consumer focus group support this finding:

> *'At the moment I would be terrified to draw down on the super, I know we have a lot more super than most people, but we need it' (female, retired 20 years).*
>
> *'Big bills, I have an overdraft with the bank and pay for it out of that and then pay that back gradually over the year. Saves using the capital' (male, retired 22 years). (McCallum, et al., 2019, pp. 17-18)*

Another consumer focus group found people have three simple ideas to manage their finances in retirement: pay off the house, receive the Age Pension and hold on to all wealth (Orford Initiative, 2019, p. 13).

[306] The shift from defined benefit pensions towards lump-sum payouts in the US was accompanied by a decline in retirement asset consumption.

Improving outcomes

The system should support people to make good decisions and get better outcomes in retirement. System cohesion at retirement would be improved if people could:

- Combine their income sources with minimal effort
- Consume more of their savings to support their standard of living in retirement

Both of these involve helping people to make decisions in the face of risks and uncertainties, and choose more optimal outcomes rather than relying on behavioural biases or inertia.

Stakeholders suggested a number of ways retirement outcomes could be improved:

- Expressing retirement income projections as an income stream may help people overcome asset framing of retirement savings.
- Increasing financial literacy, if people are willing to engage, would help people make better decisions.
- Providing guidance and financial advice about retirement options and trade-offs would reduce the amount of complexity people have to face.
- Offering a guided choice framework to help people make decisions would improve outcomes for those who would otherwise rely on defaults, such as the minimum drawdown rates.
- Simplifying the system.

Retirement income projections

Projections or estimates of a person's retirement income, which focus on future income streams rather than lump sums, can help people plan for their retirement. Specifically, they may help people to think about superannuation in terms of income, rather than an asset (Box 5A-9). The framing issue could also be overcome if converting savings into income was a default part of the system; for example, if people used part of their contributions to superannuation to pre-purchase an income stream, rather than to increase their savings balance. This would be similar to the situation with some defined benefit pensions, where people contribute to a right to an income stream.

Box 5A-9 Retirement income projections and calculators

Presenting information in a relatively simple manner can improve understanding and reduce cognitive load (Hiscox, et al., 2017).

Retirement income projections indicate the amount of income or the superannuation balance a person will have at retirement while they are in the process of saving. Projections are sent to members through periodic statements by their superannuation fund to help people plan for retirement. If presented in terms of income, projections could also overcome framing retirement savings as a 'nest egg'.

While evidence suggests income projections increase pre-retirement engagement with superannuation (Smyrnis, et al., 2019), their impact on drawing down assets in retirement has not yet been tested.

The Government has been working on a framework to encourage the use of retirement income projections and to ensure the projections are presented on a consistent basis to avoid confusing people.[307]

Similar to retirement income projections, **retirement income calculators** are available on fund websites. They allow people to calculate their retirement income by entering their own information. But current

[307] See Retirement Income Disclosure Consultation Paper (The Treasury, 2018a).

calculators are limited to calculations of expected Age Pension income and suggested superannuation withdrawals. Also, the assumptions used are not as closely regulated as retirement income projections.

Because they offer long-term estimates, assumptions are critical to the effectiveness of both calculators and projections. To help typical people balance their current and future incomes, default assumptions must be reliable and neither overly conservative nor optimistic. The assumptions needed for these calculators and projections include future rates of return on investment, expected Age Pension income and benchmark retirement income. There is a role for regulation in ensuring the assumptions used in all tools are reasonable and consistent.

The ASIC Retirement Planner on the MoneySmart website, which helps people calculate their superannuation and Age Pension income, was used by 6 per cent of the population aged 45-65 in 2019.[308]

Financial literacy

Lower financial literacy is correlated with:

- Lower superannuation balances
- Lower willingness to take financial risk
- Shorter savings horizons
- Being less likely to set up a retirement plan
- Being less informed about pension rules
- Paying higher investment fees
- Not diversifying pension assets (Lusardi & Mitchell, 2014; Preston, 2020)

However, limited evidence exists that programs aimed at improving financial literacy are effective. One meta-analysis of the international literature found that interventions to improve financial literacy explained only 0.1 per cent of the variance in financial behaviours studied, and that even extensive education programs had negligible effects on financial behaviour 20 months on from the time of intervention (Fernandes, et al., 2005). A review of the international literature concluded that the results of financial education interventions are highly variable (Beshears, et al., 2018, p. 224). The Productivity Commission recommended Australian financial literacy initiatives be subject to formal, independent evaluation for funding to continue (Productivity Commission, 2018a). In 2018, ASIC switched from a National Financial Literacy Strategy to a National Financial Capability Strategy and is now finalising a monitoring and evaluation framework.

Qualitative research done for a consumer group indicated that people did not want to be educated about superannuation; instead, they wanted assistance in making decisions (Super Consumers Australia, 2020, p. 23). Similarly, a joint paper by ASIC and the Dutch Authority for Financial Markets found that product disclosure has not solved the complexity of financial markets. Firms providing mandatory information has not necessarily resulted in informed consumers and often does not correlate with better consumer outcomes (ASIC and the Dutch Authority for Financial Markets, 2019a).

This suggests that financial literacy initiatives should not be relied on to improve engagement and retirement outcomes, given the difficulty of improving financial literacy. **Financial advice and guidance may be more likely to improve decision-making.**

[308] Data provided by ASIC for the review, 2020.

Financial advice and guidance

Providing assistance to people at retirement could help them understand their options, make better decisions and get better outcomes. This assistance can come in the form of regulated financial advice (see Box 5A-10 for specific definitions) offered by a financial adviser (unaligned or aligned with a superannuation fund) or through guidance.

Most people do not seek financial advice at retirement. Around 26 per cent of 55-64 year olds seek financial advice at retirement (Adviser Ratings, 2019). Barriers to seeking financial advice (Chart 5A-20) are outlined below.

Chart 5A-20 Barriers to seeking financial advice

Note: 2,545 survey participants from an online survey. Source: (ASIC, 2019b, p. 7).

- **Cost**. People are unwilling to pay for the full cost of personal financial advice. One survey found consumers were willing to pay no more than $500 for comprehensive personal financial advice, (Rice Warner, 2019a, p. 25) but a comprehensive retirement plan costs around $2,500 to $5,000 (Rice Warner, 2020, p. 9). Personal financial advice costs may increase in future as a result of changes aimed at improving the quality of advice, including increased professional standard requirements; changes arising from implementing the Hayne Royal Commission recommendations; and higher costs of professional indemnity insurance. However, technology may drive costs down in the future.
- **Limited finances**. People with few assets and simple financial affairs do not consider that they need comprehensive financial advice (ASIC, 2019b).
- **Lack of trust**. Almost half of those surveyed by ASIC thought advisers were more interested in helping themselves than their clients. Thirty-seven per cent thought advisers did not have their best interests at heart (ASIC, 2019b, p. 8).

Box 5A-10 What is financial advice?

Comprehensive or full personal financial advice

Comprehensive advice, otherwise known as full personal financial advice, is provided by a registered financial adviser who is licensed or authorised to provide such advice. These financial advisers must comply with a number of obligations, including the best interests duty, giving a Statement of Advice and not accepting conflicted remuneration.

The definition of personal financial advice can be ambiguous. Technically, it is defined as financial advice that takes into account an individual's personal circumstances or advice where a reasonable person might expect the adviser to have taken their personal circumstances into account (Commonwealth of Australia, 2001). This is generally the costliest form of advice.

Around 75 per cent of superannuation funds offer access to comprehensive financial advice, and around 50 per cent offer this advice in-house (others use related or contracted parties) (Rice Warner, 2019a, pp. 21-22). Currently, costs related to financial advice on superannuation may be deducted from the person's superannuation account. However, the Hayne Royal Commission recommended banning the deduction of financial advice fees from MySuper accounts.

Scaled personal financial advice

Personal financial advice ranges from comprehensive to 'scaled advice'. Scaled advice is a term often used to describe personal financial advice that is limited in scope; for example, financial advice that focuses only on whether a person should change their superannuation investment strategy (and does not, for instance, also consider whether their existing fund remains the most appropriate). The same regulations apply to scaled financial advice as full personal financial advice.

ASIC has indicated that all types of advice can be scaled, including advice about complex issues and that scaled advice can include advice on a single topic or multiple topics. Scaled advice is not lesser quality advice (ASIC, 2012a, p. 9). Around 85 per cent of superannuation funds offer single issue or scaled financial advice (Rice Warner, 2019a, p. 21).

General financial advice

General financial advice does not take into account people's personal circumstances. In most cases, financial advisers are required to warn people that they have not taken into account personal circumstances when giving the advice. In practice, it can sometimes be difficult to distinguish general financial advice from factual information and personal financial advice. The *Financial System Inquiry* (2014) recommended relabelling 'general financial advice' to increase consumer understanding of the term (recommendation 40).

Intra-fund advice

Since 2013, in an attempt to ensure retirement savings were not eroded by excessive superannuation fees, superannuation funds have been restricted when collectively charging their membership for financial advice services. Financial advice that is collectively charged for is known as 'intra-fund advice'. Because the advice a person receives is effectively cross-subsidised by other members, the scope of intra-fund advice is limited. It can be general or personal, non-ongoing financial advice limited to issues relating to a person's existing superannuation account, such as insurance coverage, contribution or investment options (Commonwealth of Australia, 1993). Intra-fund advice currently cannot consider a person's circumstances outside their interest in the superannuation fund, such as social security eligibility, health, aged care needs and assets held outside the fund. These limits on scope mean intra-fund financial advice is of limited assistance at retirement. Many stakeholders argue the intra-fund advice provisions should be expanded for the retirement phase. This would give most retirees access to personal advice they do not directly pay for.

Digital advice

Digital (or robo or automated) financial advice includes automated financial advice that uses algorithms or technology to offer financial advice. It can be provided directly to people, or a financial adviser could use the tool to assist them to give advice. As the financial advice legal framework is technology-neutral, the same requirements apply to digital financial advice, whatever category of financial advice is provided.

What is not financial advice?

Guidance

This is advice or assistance provided to people that does not relate to a financial product recommendation. For example, guidance at retirement could include assistance on:

- The best age to retire
- Their Age Pension entitlements
- Their financial position and debts and assets
- How and when to pay down debt
- Their likely future living expenses
- Their retirement income needs

While guidance of this nature is unlikely to fall with the definition of regulated financial advice, the definition of what constitutes financial advice is not always clear, and this ambiguity may explain funds' reluctance to offer guidance.

Factual information

ASIC Regulatory Guide 244 (2012a) uses the concept of 'factual information'. Factual information is objectively ascertainable information, the truth or accuracy of which cannot reasonably be questioned.

Potential benefits of financial advice

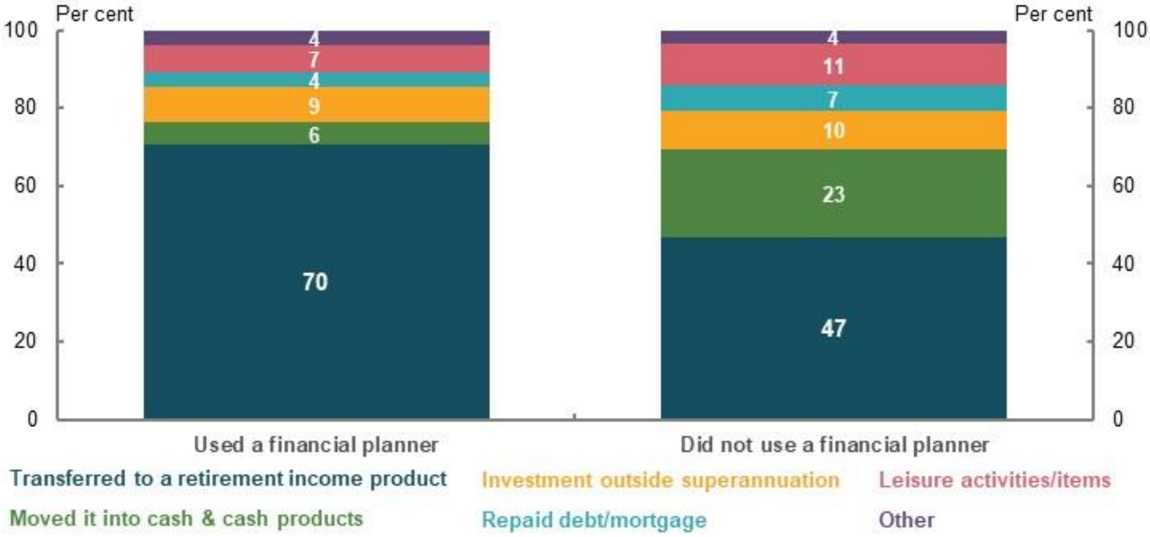
Stakeholders pointed out the potential benefits of financial advice, including:

- **Better income management**. For most people, the main barrier to receiving a predictable income stream in retirement is working out how best to combine multiple sources of income
- **Increased confidence and peace of mind**. One fund reported that the bulk of advised clients felt more peace of mind and confidence in making decisions (MLC Wealth, 2020, pp. 24-25). Surveys have also found positive emotional outcomes for people receiving financial advice (Vanguard, 2019). Half of respondents to another survey who had received advice said their mental health had also benefited from receiving financial advice (Fidelity International, 2019)
- **Better investment decisions**. One American study found that seeking financial advice may lead to better investment decisions (Kinniry Jr., et al., 2015), which may increase the likelihood of money lasting during retirement, or increase retirees' income, allowing them to have a better standard of living. Another US study indicated retirement income could be increased by 22.6 per cent by using a better retirement income strategy, such as using annuities or choosing a better drawdown strategy (Blanchett & Kaplan, 2013). However, some of the suggestions discussed in the American literature on financial advice are already available at low cost for most people in Australia through defaults that exist in the pre-retirement phase. For example, MySuper products offer people balanced and diversified investments without seeking advice

Defaults in the retirement phase, such as the proposed Comprehensive Income Products for Retirement, combined with guidance, could lead to a better drawdown strategy and greater take-up of products that efficiently manage risks, such as longevity risk.

In Australia, the data indicates benefits from financial advice: people who did not use a financial adviser at retirement transferred a much larger proportion of their wealth into cash and equivalents (Chart 5A-21), a strategy that would likely lead to lower income during retirement. Box 5A-11 discusses evidence showing the benefits of financial advice on investment switching behaviour in an economic crisis.

Chart 5A-21 How retirement savings were used by retirees, by use of a financial planner



Note: 651 respondents. Source: Investment Trends October 2017 Retirement Income Report.

Box 5A-11 The benefits of financial advice in an economic crisis

- Falling markets can be stressful. The complexity of navigating the system is an issue, particularly during downturns (Bateman, 2009). Complexity, combined with fear and uncertainty, can lead people to make poor choices, such as switching assets to cash during periods of market volatility. Switching can protect balances from further falls in the short term, but means members are likely to miss out on any rebound in markets. As cash delivers significantly lower return than balanced funds over the long run, this behaviour typically impairs retirement outcomes.
- Forthcoming research by a large fund points to the importance of guidance and advice in reassuring members and helping them stay the course when markets fall. The fund comprised two broad groups of retirees: one where retirees were largely self-directed, while the other group typically received financial advice. Key member characteristics and aggregate asset allocations were otherwise broadly similar across the two groups. Following the sharp market downturn in March 2020, just 0.9 per cent of funds under management for the largely advised group was switched, while 11 per cent of funds under management for the self-directed group was switched. Across both groups of members, close to 80 per cent of switches were into a more defensive investment option, with around 50 per cent of these being switches to cash.
- Earlier research by the same fund found that 83 per cent of the self-directed group aged over 50 who switched to a more defensive option during the GFC, missed the rebound in markets and had not switched back by the end of June 2010. This suggests that members who switch during periods of market stress may not switch back without prompting, further emphasising the value in ready access to advice and guidance.

Outcomes from financial advice

Variable outcomes from financial advice have been well documented by ASIC and more recently by the Hayne Royal Commission, which highlighted several instances of poor consumer outcomes from financial advice.

- A 2012 ASIC shadow-shopping exercise on retirement advice found only 3 per cent of advice was good and 39 per cent was poor, with advice overly focused on the merits of particular products. ASIC found much of the advice did not help clients to develop a realistic and achievable plan for their retirement or make the most of their financial resources. This review was conducted before the Future of Financial Advice reforms (ASIC, 2018a).
- In 2016, ASIC released a report finding widespread instances of people paying for financial advice, but not being delivered any services (ASIC, 2016a). Many of these instances involved

superannuation products where advice fees were being deducted directly from the product, reducing the affected client's future retirement income.

- In 2018, ASIC reviewed the quality of financial advice and compliance provided by vertically integrated firms and found that 75 per cent failed to comply with the requirements associated with the best interests duty, but the quality of advice had improved after the Future of Financial Advice reforms. However, ASIC found only 10 per cent of files showed that consumers would be significantly worse off as a result of following the financial advice.
- In 2019, ASIC looked at financial advice offered by 25 superannuation funds and found 49 per cent complied with the best interests duty, with the member at risk of suffering detriment in 15 per cent of cases, and the other failures mostly due to disclosure and record-keeping failures (ASIC, 2019d). ASIC noted:

> *'Superannuation funds play an important role in meeting the financial advice needs of Australians. Good financial advice can result in members making the most out of their superannuation savings upon their retirement. Poor financial advice, however, can significantly impact a member's financial position and retirement plans.' (ASIC, 2019d, p. 7)*

Recent changes to financial advice regulation and further reforms in light of the Hayne Royal Commission may improve financial advice outcomes for consumers.

Changes in response to the Hayne Royal Commission, such as removing grandfathered arrangements for conflicted remuneration and introducing a Code of Ethics banning commissions[309] are expected to lead to more strategic financial advice. In this case, advisers are paid for strategic recommendations rather than advice focused on getting consumers to take up products for which the adviser receives a commission.

Advisers are already shifting away from commissions to a fee-for-service model (Adviser Ratings, 2019), which makes the cost of advice more transparent. While the recently introduced professional standards for financial advisers are likely to improve adviser competence,[310] these reforms may reduce the supply of financial advisers if some advisers fail or choose not to meet the new standards. The effectiveness of reforms aimed at improving the quality of financial advice will be reviewed by Government in 2022.

Technology options around financial advice

Digital financial advice offers a potential solution to make getting assistance for retirement both efficient and affordable. Depending on design, greater use of digital financial advice may also reduce costs and biases and improve outcomes. But the following barriers and limitations to digital financial advice would need to be addressed:

- **Take-up of digital financial advice is low, and the tools for retirement are limited**. An ASIC survey in August 2019 showed only 1 per cent of respondents had used digital advice, and only 19 per cent were open to digital advice once it was explained to them (ASIC, 2019b, p. 5). In the

[309] In 2019 the *Treasury Laws Amendment (Ending Grandfathered Conflicted Remuneration) Act 2019* was passed, extending the ban on product providers paying financial advisers in relation to certain financial products that were exempt from the ban from 1 July 2021. From 1 January 2020 financial advisers have been required to comply with the Financial Adviser Standards and Ethics Authority Code of Ethics Standard, which prohibits them from receiving benefits from third parties.

[310] The Government introduced new education (including a degree equivalent), training, exam and ethical standards for financial advisers, which commenced this year. More information on the requirements is available at the Financial Adviser Standards and Ethics Authority website: https://www.fasea.gov.au/.

US, the use of digital financial advice is increasing rapidly (Statista, 2020) but anecdotal evidence suggests it is generally used to guide investment rather than retirement strategies. Current digital financial advice tools cannot calculate an appropriate retirement strategy for a household, although some are in development.[311]

- **People do not trust digital financial advice**. Younger and higher-income people are more likely to welcome automated financial advice.[312] Trust in digital financial advice and guidance improves when people experience it (Lochner, et al., 2017). This suggests trust in digital advice may increase in future. People may also trust digital financial advice tools more if outcomes are delivered by a person.
- **People may not be willing to pay for digital financial advice**. Consumers expect digital financial advice to be free or cheap (Lochner, et al., 2017). Rice Warner (2019a, p. 25) found consumers were willing to pay less than $250 for digital financial advice. Although ongoing costs are low, financial providers offering digital financial advice incur significant upfront software costs.
- **Regulatory barriers may prevent creating and using digital financial advice tools for retirement**. Some argue that there is legal uncertainty around fulfilling financial advice obligations when there is not a person involved in delivering the advice (Soljo & Blades, 2019), although ASIC has issued regulatory guidance on providing digital financial advice (ASIC, 2016b).

Guidance

The complexity of retirement means people often need assistance that may not include a recommendation relating to a financial product (Box 5A-10). Nevertheless, any legal uncertainty about whether guidance of this nature would require providers to comply with financial advice obligations would increase the costs of providing guidance. In the absence of certainty, providers are likely to comply with the obligations to avoid any risk of breaching the law. Funds may also be reluctant to provide guidance because these services are likely to require significant investment and ongoing costs.

The Financial System Inquiry envisaged a greater role for superannuation trustees in guiding retirees into retirement, including designing a pre-selected product for the member. These pre-selected products are known as a 'Comprehensive Income Products for Retirement'. One stakeholder noted trustees should offer these services as part of offering retirement phase products (Rice Warner, 2020, p. 9).

The same technology that facilitates digital advice could be modified to help funds offer guidance to members in a cost-effective way. It could also be used by Government to offer guidance directly to individuals, through better use of tools such as calculators (Box 5A-9).

In the UK, the Financial Conduct Authority recommends making providers assess whether consumers are eligible for enhanced annuities (annuities for low life expectancy), by asking simple health and lifestyle questions, and then offering the best enhanced annuities on the market. In Australia, the Government's proposed Retirement Income Covenant suggests a greater role for superannuation funds in guiding members at retirement (Box 5A-12). The covenant envisages a guided choice framework in the form of a retirement income strategy for fund members that provides higher and more stable income in retirement than the current 'default' settings.

[311] One company has announced it is developing a tool for advisers to assist advisers to provide advice retirement income solutions for retirees.
[312] Lochner et al. (2017) used a randomised control trial to assess consumers' willingness to use automated financial advice for basic decisions.

Box 5A-12 The Retirement Income Covenant

To develop the retirement phase of the superannuation system, in the 2018-19 Budget[313] the former Minister for Revenue and Financial Services, the Hon Kelly O'Dwyer MP, announced plans to create a legal obligation on superannuation funds to consider their members' needs in retirement and develop an appropriate retirement income strategy (see the Government's Retirement Income Covenant Position Paper).[314] This built on the Government's response to the 2014 Financial System Inquiry, in which the Government committed to develop legislation to allow funds to provide pre-selected products at retirement and guide members at retirement.

This would complement the current legislative framework, the *Superannuation Industry (Supervision) Act 1993 (SIS Act),* which has specific obligations in superannuation law that impose duties (called covenants) on trustees of superannuation funds that apply to the pre-retirement phase.[315] (The retirement phase currently has no specific legal framework.)

Under the new obligations, trustees would be required to consider how to manage members' retirement risks, such as longevity and inflation, their Age Pension eligibility, any need for access to capital, as well as the risk of cognitive decline. Trustees would also be required to develop and offer a Comprehensive Income Product for Retirement: a retirement income product that is likely made up of a combination of products, which provides broadly constant income for life (that is, it manages longevity risk) and some access to capital.

As part of the Retirement Income Covenant, trustees would have a legal responsibility to guide members at retirement (guided choice) by providing financial advice, information or guidance to help them understand and make choices about retirement income products.

Future roles providing guidance and financial advice

When people receive assistance it must be paid for, either by the Government, from people's superannuation accounts or directly by the people accessing the assistance.

Role of superannuation funds

Superannuation funds are well placed to provide both guidance and financial advice at retirement (or prompt people to seek financial advice) because members have to contact their fund to transfer their assets into the tax-free retirement phase and to start accessing their savings. This guidance could relate to a product, or it could relate to another strategy, such as, for low balance holders, using their superannuation to pay down debt.

Arguably, given retirement income is the core purpose of superannuation, funds have a responsibility to provide this guidance. However, the regulatory framework does not make it easy for funds to provide such guidance. Anecdotal evidence suggests some funds are reticent to provide guidance to people at retirement as there is legal ambiguity over what is and what is not financial advice.

Under superannuation law, trustees are required to act in the best interests of their membership as a whole, which means they are focused on factors such as keeping costs for the entire membership down and trying to maximise funds under management. This may not be in the interests of an individual member. For example, funds may be inclined to offer or recommend products or strategies that involve members drawing down their retirement savings more slowly. Further, advisers

[313] See Media Release 'Helping make your super work harder in retirement', released on 17 May 2018: https://ministers.treasury.gov.au/ministers/kelly-odwyer-2016/media-releases/helping-make-your-super-work-harder-retirement.

[314] See Retirement Income Covenant Position Paper: Stage one of the Retirement Income Framework: https://treasury.gov.au/sites/default/files/2019-03/c2018-t285219-position-paper-1.pdf.

[315] See sections 29VN and section 52 of the *Superannuation Industry (Supervision) Act 1993*).

associated with funds may have an incentive to recommend their fund's products. This could dampen the already limited competitive forces in the retirement income product market. At present, this risk is likely to be small. Of note, product quality regulation has been used in the pre-retirement phase to tackle the risk of poor outcomes from the lack of competitive forces.

Overall, **giving funds the confidence to provide limited and targeted guidance to members without needing to comply with the legal obligations associated with financial advice would likely improve people's retirement outcomes**. The benefits associated with drawing down more retirement savings and higher standards of living in retirement, coupled with effective regulation, would likely outweigh any potential impact from conflicts of interest.

Role of Government

The Government currently provides guidance through ASIC's MoneySmart website and the Financial Information Service. The Government promotes these services through Financial Health Checks for 45- and 65-year-olds.

- **MoneySmart** provides a retirement income calculator and general information, but does not assist people to make decisions. It directs people to seek financial advice.
- **Financial Information Service** provides seminars and phone guidance. It was originally targeted at pensioners but now has a broader role.

Some stakeholders argued the Government should offer affordable guidance at retirement, based on the UK's Money and Pensions Service (Box 5A-13) (Super Consumers Australia, 2020, pp. 29-30). Although the UK model gives retirees access to affordable and independent guidance at retirement, it does not guarantee people will seek this guidance or advice. Research by the UK's Financial Conduct Authority found many of those approaching retirement had not received advice (Financial Conduct Authority, 2019).

Stakeholders suggested a number of roles the Government could play in the retirement phase, including:

- **On products.**
  - Regulating the quality of retirement income products
  - Introducing product standards to allow for better comparability between products (akin to its role in the pre-retirement phase for MySuper products)
  - Developing a comparison tool to encourage competition
- **On guidance or financial advice.**
  - Providing guidance at retirement, especially around generic retirement income strategies for people based on broad characteristics (e.g. gender, couple status, net wealth)
  - Funding/subsidising the cost of financial advice
  - Directly providing financial advice by employing financial advisers

Box 5A-13 The UK's Money and Pensions Service

In the UK, providers are required to direct retirees to the service and send a 'wake up pack' to retirees at age 50. The service conducts research on the best way to engage with retirees. Retirees are given a free session, which could be seen as 'simple advice'. More complicated cases are directed to a list of 'trusted' financial advisers. The service is funded by an industry levy.

Role of financial advisers

While the affordability of financial advice remains an issue, technology may bring down costs. ASIC has suggested industry or Government could subsidise basic financial advice services, so they can be provided at low cost (ASIC, 2018b, p. 13).

The fee-for-service model that many financial advisers now use may mean that unaligned financial advisers are less conflicted than superannuation funds when they provide financial advice. This may encourage a more competitive retirement product market. However, financial advisers may have an incentive to recommend retirement products that require an adviser's frequent involvement, such as an account-based pension, rather than a 'set and forget' product, such as a lifetime annuity or other longevity risk management product.

Box 5A-14 Stakeholder views on the financial advice framework

Many stakeholders suggested the financial advice framework was failing to adequately meet the range of needs of people approaching and in retirement. Stakeholders suggested ways to improve the financial advice framework and/or facilitate funds to provide greater assistance to members.

Facilitating more affordable scaled and digital financial advice

The regulatory requirements are identical for scaled, digital and comprehensive financial advice regardless of how simple or complex the advice is. Although ASIC has issued material to try to promote scaled advice,[316] affordable scaled and digital financial advice is in limited supply.

To address this gap, some stakeholders suggested providing greater regulatory certainty around providing scaled financial advice, such as developing and defining specific, limited personal circumstances (e.g. Age Pension eligibility and health status) that must be taken into consideration by financial advisers. Others suggested creating simple retirement income solutions, appropriate to most circumstances, could also facilitate the use of scaled financial advice.

Stakeholders noted that making scaled advice more affordable may mean more people are likely to seek advice. This might facilitate greater development of technology-assisted, or digital financial advice and guidance.

One stakeholder argued funds are well placed to fill the gap left by existing financial advisers (Rice Warner, 2019a).

Expanding the intra-fund advice provision

Intra-fund advice currently cannot consider an individual's circumstances outside their interest in the superannuation fund, such as social security eligibility, health, aged care needs and assets held outside the fund. Stakeholders called for the intra-fund advice arrangements to be expanded to allow these factors to be considered to improve access to advice approaching retirement. While this could make financial advice more affordable for a given person, such changes would not make the system-wide costs of financial advice more affordable. They could lead to younger fund members subsidising members approaching retirement. As the

[316] For example, ASIC has issued an example Statement of Advice for scaled advice, see https://asic.gov.au/regulatory-resources/find-a-document/regulatory-guides/rg-90-example-statement-of-advice-scaled-advice-for-a-new-client/.

true cost of intra-fund advice is hidden by cross-subsidisation, expanding these arrangements may lead to less transparency around costs.

Of note, funds are not restricted from providing broader personal advice individually charged to the member.

Providing greater guidance

Some stakeholders argued that clearly articulating that guidance was not subject to the financial advice framework could facilitate greater fund communication with people approaching and at retirement.

Similarly, many submissions recommended the Government implement the Retirement Income Covenant, which would encourage funds to guide their members at retirement, essentially through a 'guided choice' or decision-making framework (see Box 5A-12).

Guided choice and innovative retirement income products

Compared to the pre-retirement phase, the retirement phase involves more complex decisions. However, it has no default arrangements. Stakeholders proposed that a guided choice framework[317] at retirement, offered by superannuation funds, could simplify the experience for many. It could create pathways for people to choose between, or a reference point from which they can compare different retirement strategies. It could also be accompanied by financial advice or guidance.

The literature suggests that guided choice frameworks can 'nudge' people where there is uncertainty around the best course of action to help them make a decision (Thaler & Sunstein, 2008). The UK, for example, will assist unengaged consumers with small balances, by mandating four investment pathways that every defined contribution pension provider must offer when someone reaches age 55. This is consistent with the concept of reducing choice overload, where people are able to engage better when the number of options are limited (Cronqvist & Thaler, 2004).

Some stakeholders pointed out the difficulty of designing retirement income strategies that would suit a group of retirees with different life expectancies, Age Pension entitlements and preferences. Defaults can reduce competition (Productivity Commission, 2018a) and need to be designed carefully to avoid adverse outcomes. However, in the absence of a strategy designed for consumers, account-based pensions at minimum drawdown rates are effectively acting as a default strategy for all retirees.

Stakeholders have indicated that an improved range of products is needed to align with people's consumption patterns in retirement and provide longevity risk protection for those who need it (Box 5A-15). Products are needed that provide a reasonably stable income without the need for regular monitoring, flexibility to withdraw a lump sum, and longevity risk management if necessary. Retirees find it difficult to combine a portfolio of available products that provide both flexibility and longevity risk management (including the Age Pension).

Box 5A-15 The annuities market in Australia

Annuities take different forms, but all manage longevity risk through paying a regular income stream for the designated period, giving people confidence to spend their retirement savings. Term annuities are the most common type of annuity in Australia, (Mercer, 2014, p. 2) but they do not completely manage longevity risk as they provide an income stream only for the designated period. The two main types of products that fully manage longevity risk are:

1. Life annuities, which are capital-backed, offered by a registered life insurance company and pay a guaranteed amount of income.

[317] A guided choice framework can be thought of as a 'soft default' where people are nudged towards a certain path, but have to consent to the option.

2. Group self-annuitised products, which can be administered by superannuation funds and involve people pooling their money to create an income stream that is subject to market risk and the mortality experience of the pool.

Annuities can be immediate (i.e. they start straight away) or deferred (e.g. they may commence in 10 years).

Despite the potential for annuities to provide a stable income for life, and more efficient use of retirement income, the take-up of annuities in Australia is very low. Of pension phase accounts, around 6 per cent are invested in annuities (Australian Prudential Regulation Authority, 2020a). Attractive structuring of these products is challenging in a low interest rate environment.

Low take-up of annuities is not unique to Australia. Economists call the fact that people invest very little in annuities, even though they facilitate consumption smoothing, the 'annuity puzzle'. It has led to many countries (such as Austria, Iceland, Ireland, Italy, the Netherlands, Norway, Sweden and Switzerland) mandating at least partial annuitisation at retirement. For an explanation of the academic literature on the annuity puzzle see (Beshears, et al., 2018, pp. 205-210).

Research shows that people would take up Comprehensive Income Products for Retirement products that combine income, risk management (e.g. longevity risk management) and flexibility (e.g. to access a lump sum) if these products were offered. A 2017 experiment by the Behavioural Economics Team of the Australian Government (BETA) on the take-up of Comprehensive Income Products for Retirement found:

> *'On average members were around 50% willing to choose the CIPR if it were offered to them in the future. Given the lack of product diversity (94% of retirement assets in Australia are currently allocated to ABPs) and the fact that CIPRs are a new product, this level of interest is encouraging and suggests CIPRs may do well (in terms of customer take-up) in the market.' (Hiscox, et al., 2017, p. 7)*

More recent research suggests that while people are interested in annuity products, they find the process of choosing between specific products too difficult (Orford Initiative, 2020). This suggests there may be a role for guidance and financial advice in encouraging people to make more use of annuities.

In recent years, the Government has removed some of the barriers to people taking up products that manage longevity risk:

- In 2017, the Government passed legislation to allow eligible longevity risk management products to receive the tax exemption on earnings in the retirement phase. This was part of the *2016-17 Budget and related superannuation* reforms.
- In 2019, the Age Pension means-testing rules were created for pooled lifetime income streams to clarify their means-testing treatment. This was part of the *More Choices for a Longer Life 2018-19 Budget package*, and was in response to stakeholder calls for the social security settings to incentivise the use of these products.

The Retirement Income Covenant (Box 5A-12) is also designed to encourage take-up of products that manage longevity risk by requiring superannuation funds to consider whether they should develop and offer a Comprehensive Income Product for Retirement.

To address these issues, some stakeholders have called for simple regulated products suitable for most people and satisfy minimum requirements (akin to MySuper products) to be developed for the retirement phase. Given these products would be standardised and regulated, funds and financial advisers could potentially provide guidance on these products outside of the financial advice framework. The Government has consulted on creating a framework for Comprehensive Income Products for Retirement that would meet minimum standards and provide income higher than an account-based pension drawn down at minimum rates, alongside flexibility and longevity risk management (The Treasury, 2016b). Under the proposal, if a financial adviser recommended another type of product they could be required to justify why that product was better for their client (The Treasury, 2016b, p. 38).

Other products that could improve retirement outcomes include long-term care insurance, for people who are uncertain if they are likely to need to fund aged care costs (Box 5A-6). If changes are made to encourage greater personal provision for aged care costs following the Aged Care Royal Commission, long-term care insurance may make aged care costs more affordable for people and give them the confidence to draw down their retirement savings. If arrangements stay the same, more information and guidance about the likely costs of aged care, and the fact that it is not necessary to fund costs through a lump sum, may negate the need for long-term care insurance.

A simpler system

A large number of stakeholders observed that simplifying the system, especially reforms to the design and administration of the Age Pension means test, would allow people to better understand their likely retirement outcomes.

Several stakeholders noted the complexity of administrative arrangements at retirement (Box 5A-16). Some noted that people experience delays in accessing the Age Pension caused by the complex nature of application requirements, poor understanding of the system, procrastination and stigma around dealing with Government agencies. After a person has been found to be eligible for the Age Pension, they face ongoing reporting requirements. An analysis of Age Pension data found 82 per cent of age pensioners had more than four variations in their pension benefit amounts each year, the majority of which were for minor amounts of less than 3 per cent of the payment (Centre for Law, Markets and Regulation, 2020, p. 21).

Age Pension means test

Submissions and stakeholders proposed various options to simplify Age Pension means testing, including:

- **Removing means testing and creating a universal Age Pension**. This could reduce administrative costs and create certainty for retirees. However, it could cause equity issues and, in the absence of other changes, cost significantly more than the current Age Pension[318]
- **Merging the income and assets tests**. A merged means test would combine the income test and an asset consumption factor, so only one test would apply (see *Appendix 6B. An example to illustrate the trade-offs of merging the income and assets tests).* Some stakeholders proposed it could vary by age to be fairer between age pensioners (Centre for Law, Markets and Regulation, 2020, p. 28). In doing so, a merged means test could provide part Age Pension recipients with a flat income profile. Any change to the means test could affect equity outcomes. Depending on the test's design, it could have a positive or negative effect on horizontal and vertical equity.[319] While it would remove the need for two tests, a merged means test could be more complex for people to understand
- **Creating a one-off means test**. This would give age pensioners income certainty and reduce ongoing administrative costs. But review mechanisms would be needed to reflect significant changes in circumstances; for example, after suffering an expensive health shock or receiving an inheritance

[318] The cost of a universal pension could be more than $80 billion (in 2018-19 dollars), compared to $46 billion under the current system.
[319] Horizontal equity: the idea that people with similar income and assets should pay the same amount in taxes. Vertical equity: the idea that people with higher incomes should pay more tax.

Box 5A-16 Requirements to access Age Pension and superannuation benefits

To access the Age Pension, people must:

- Provide proof of identity, in person and with supporting documents, unless previously part of the social security system
- Report on their income and asset values, which are self-assessed but must be in line with a range of valuation methodologies. This often requires further supporting documents
- Continue to report changes in circumstances, including changes to income and assets

To access superannuation benefits, people must:

- Notify the superannuation fund that a condition of release has been met (usually retiring after preservation age)
- Select a retirement income product from their own or another superannuation fund. In either case, administrative processes will be involved in purchasing the product

  OR

- Withdraw benefits from the superannuation system

To change a superannuation retirement income product, people must:

- Commute the 'retirement phase' product back to the pre-retirement (or accumulation) phase before it can be transferred to the new product
- If the new product is with a different fund, open an accumulation account in that fund before the new pension product can be purchased

These complex steps are in place because of the need to prevent fraud, the different taxation arrangements for the pre-retirement and retirement phases and the need to identify taxed and non-taxed amounts.

Superannuation tax: one product for life

Different tax arrangements for superannuation in the pre-retirement (or accumulation) phase and the retirement (or pension) phase create complexity. Some stakeholders have suggested that aligning the tax arrangements would:

- **Allow people to have a single superannuation account for life**. Pre-retirement and retirement phase accounts would have the same tax and administrative arrangements, making the $1.6 million transfer balance cap redundant
- **Simplify the process for changing superannuation funds in retirement**. People would not need to commute a retirement phase account back to the pre-retirement phase before transferring to a new fund
- **Simplify superannuation for people who return to work after retiring**. The SG received from employment could be deposited in the same superannuation account from which a pension is being drawn, removing the need to hold multiple accounts and pay multiple fees

However, if this change was made in the absence of other changes to assist people at retirement and encourage them to consume their retirement savings, many people would likely remain in pre-retirement products and would preserve their retirement savings. This would lower standards of living in retirement.

Administrative requirements

People must go through numerous administrative processes and requirements to access the Age Pension and superannuation benefits (Box 5A-16). Proposals to reduce this administrative burden include:

- **Simplifying the system.** Some of the simplification options discussed above, such as a universal Age Pension or a one-off means test, could also reduce reporting requirements for retirees.

However, these changes may have equity trade-offs, require changes to other parts of the system or shift the administrative burden from one area of the system to another

- **Data-sharing and pre-filling information.** This could make application processes and reporting requirements easier, drawing on indirect data sources. For example, Services Australia now uses data collected from superannuation funds and income stream providers to automatically adjust pensioners' assets and income information
- **Greater integration.** This could reduce inefficiencies, avoiding the need to give different Government agencies the same information. The Government is making progress towards a 'tell us once' capability. For example, work is underway to create a 'Digital Pass' for online Government services, so people do not need to prove their identity multiple times

Box 5A-17 Impact of changes to certain policy settings on cohesion

A significant number of submissions put forward policy suggestions to change the cohesion of the retirement income system. The following summary outlines some of the implications of some of the proposed changes to particular policy settings.

- **Lower the Age Pension assets test taper rate.** This would run counter to the objective of encouraging retirees to more efficiently draw down their assets. Even though it would slightly lower the effective marginal tax rate on retirement savings, they would remain high, and the overall disincentive to save would remain.
- **Introduce a merged means test for the Age Pension.** This may encourage people to draw down more from their assets in their later years of retirement. However, depending on the design of the merged means test, it may not significantly reduce system complexity. There would continue to be significant differences between the means tests for the Age Pension and for aged care.
- **Change superannuation tax concessions and incentives to work.** The SG is the main driver of retirement savings for most people, not voluntary superannuation contributions. Most voluntary contributions are made by people who would likely reallocate those savings to the next most tax-effective savings vehicle. Removing financial incentives to work would have little impact on people's behaviour, as financial incentives are largely ineffective at changing behaviour and benefit those who would continue to work anyway.
- **Encourage people to use their assets more efficiently in retirement.** This would lead to a higher standard of living in retirement. Alternatively, people could save less and achieve adequate retirement incomes to maintain their standard of living in retirement while having a higher standard of living in their working life (see *2D. Policy scenario: Implications of maintaining the SG rate).*
  - **Implementing the Retirement Income Covenant would provide a decision-making framework to assist people at retirement.** The covenant would require superannuation funds to provide guidance to their members at retirement, which would simplify the experience for people and encourage them to more efficiently draw down their savings.
  - Increasing the minimum drawdown rates would likely increase retirement incomes and may lead to higher living standards for the majority of retirees who use these rates as a 'default drawdown strategy'. However, increasing the minimum drawdown rates without providing longevity risk protection could lead to income shock for some retirees. Retirees would likely benefit more from a more tailored drawdown strategy that accounts for factors such as Age Pension eligibility, couple status and age of retirement, instead of a one-size-fits-all drawdown rate.

Section 5B. Policy scenario: Implications of changing Age Pension means test settings

Box 5B-1 Section summary

A lower assets test taper rate

- **Many stakeholders supported lowering the assets test taper rate. The short-term benefits of a lower taper rate would primarily go to retirees in the upper half of the wealth distribution.** Lower wealth retirees who receive a full pension, or are means tested by income, would not be affected by changes to the assets test.
- **As the superannuation system matures, most retirees would receive additional income from a lower taper rate.** Almost two-thirds of retirees are projected to receive a part-pension by 2060 as a result of higher household assets.
- **A lower taper rate would increase replacement rates for middle-income earners and increase fiscal costs.** Projections suggest replacement rates for this group would exceed the 65-75 per cent benchmark under current policy settings. For illustrative purposes, the fiscal cost of lowering the taper rate to 2.25 per cent would be around $1 billion in 2019-20. This would grow to 0.20 per cent of GDP in the long term as the superannuation system matures and more households are affected by the assets test.
- **A lower taper rate would provide more reward for additional savings.** But evidence suggests savings behaviour may not change significantly in response.
- **A lower taper rate would reduce incentives for retirees to draw down their assets in retirement.** The impact of this incentive on drawdowns is uncertain. It may be small in the presence of other behavioural factors, such as anchoring to minimum drawdown rates.

Merged means test

- **Some stakeholders proposed merging the income and assets tests to reduce the complexity of the Age Pension means test.** Merging the income and assets tests would involve trade-offs between the system's objective of adequacy, equity, sustainability and cohesion.
- **Abolishing the assets test would simplify the means-testing arrangements.** But this would increase Age Pension expenditure and primarily benefit retirees with significant asset levels.
- **Replacing the assets test with a capital consumption component in the income test may improve equity.** But, depending on the design, it may increase complexity.
- **It would be challenging to design a merged means test that achieves the objective of the current dual means test but is less complex.**

Outline of this section

A number of submissions called for a reduction in the Age Pension assets test taper rate. Others proposed merging the income and assets test. To improve understanding of the impact of changing the Age Pension means test settings, this section considers the implications of a lower assets test taper rate and the trade-offs of merging the Age Pension income and assets tests.

Box 5B-2 Stakeholder views on the Age Pension means test

Most stakeholders who raised the Age Pension means testing supported lowering the taper rate. Many said the current taper rate excessively penalises middle-income earners, with the high effective marginal tax rates discouraging saving. Others claimed it distorts incentives by encouraging spending to avoid the assets test, which may reduce self-sufficiency and increase longevity risks.

Some stakeholders said the taper rate means households with higher wealth can have lower incomes than lower-wealth households:

> *'The system as it stands is perverse. For many, the more they save the worse they are, because of the assets test taper rate.' (National Seniors Australia, 2020)*

Others raised fairness concerns, noting the assets test particularly affects middle-income earners:

> *'Changes to the Age Pension assets test taper rate in 2017 demonstrate how the absence of an objective for the retirement income system created significant inequities for middle Australia that threaten the integrity of the system.' (Australian Institute of Superannuation Trustees, 2020)*

Some submissions supported a high taper rate, noting it would reduce Government expenditure and improve sustainability.

Some stakeholders disagreed that the $3 taper rate would lead to lower retirement incomes, pointing out that retirees with higher wealth can consume their assets and the system should encourage this.

Some stakeholders advocated that a merged means test would be an improvement over the current dual means test as it would:

- Create a simpler means test framework, which may be easier to administer and understand
- Ensure a consistent measure of a person's total means. The current dual means test can result in people with different levels of assets and/or income receiving the same Age Pension

Design of the Age Pension means test

Means testing in the retirement income system reduces Age Pension payments based on retirees' income and assets. The Age Pension means test consists of two elements, applying whichever test gives the lower rate of pension.[320]

- **The income test** takes account of a retiree's income from employment and financial assets. The Age Pension payment is reduced by $0.50 a fortnight for each dollar of income over the income test free area.
- **The assets test** reduces a recipient's pension payment by $3 a fortnight for every $1,000 in assessable assets over the assets test free area. This rate of reduction in the Age Pension payment is known as the 'assets test taper rate', which reduces the Age Pension at a rate of $7.80 for every $100 in assessable assets.

[320] Both tests exempt the principal residence. See *3C. Home ownership status* for discussion on the implications of this for home owner and non-home owner retirees.

- Most people affected by the means test are income tested, with the assets test applying to those with significant wealth. This recognises the capacity of wealthy retirees to draw down their asset holdings to support their retirement (see *2A: Design of Australia's retirement income system).*

As a large number of stakeholders advocated reducing the assets test taper rate, this section outlines some of the implications of a lower taper rate.

Implications of a lower assets test taper rate

The current assets test taper rate has several strengths. It creates an incentive for retirees to use the assets they have saved for retirement, and helps ensure Age Pension payments go to those in need. Limiting eligibility contains the fiscal cost of the Age Pension.

A number of stakeholders argued the current system could distort incentives to make additional superannuation savings for retirement and, under certain assumptions, lead to lower total income for retirees with higher balances (see *5A. Cohesion*). Many stakeholders pointed to high effective marginal tax rates due to the taper rate exceeding the expected return on savings.

As the superannuation system matures, an increasing number of retirees will be assessed under the assets test. The proportion of part-rate age pensioners who will be assets tested is projected to rise from about one-third in 2020 to two-thirds by 2060 (see *4. Sustainability*).

To consider the implications of changes to the taper rate, a scenario with a $2.25 taper rate was chosen for illustrative purposes. This is within the $2-$2.25 range proposed by a number of stakeholders. For simplicity, the assets test free areas were maintained at their current levels.

Effect on adequacy

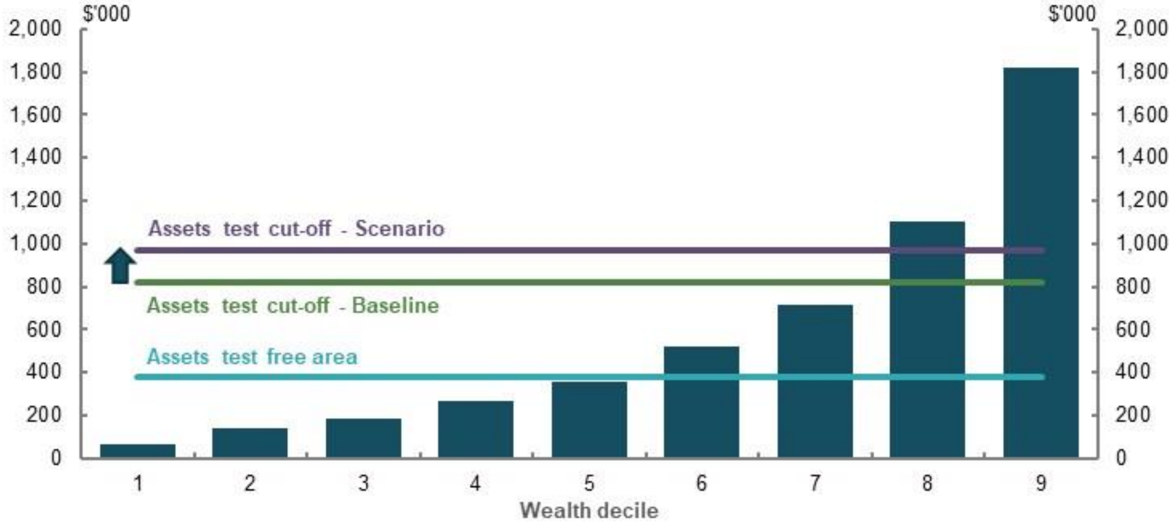
Short-term impact on retirement income

Sixty-one per cent of current Age Pension recipients have income and assets below the relevant free areas and receive a full Age Pension. This group would see no additional income from this change. **The immediate benefits of lowering the taper rate would go to part-rate age pensioner recipients subject to the assets test, who make up 13 per cent of all age pensioners**.

Retirees with assets just above the assets test cut-off who currently receive no Age Pension would also benefit by starting to receive a small part-pension. These retirees are in the top half of current retirees by wealth (Chart 5B-1).

Chart 5B-1 Change in asset-tested area from current policy to $2.25 taper rate by wealth decile

Assessable assets

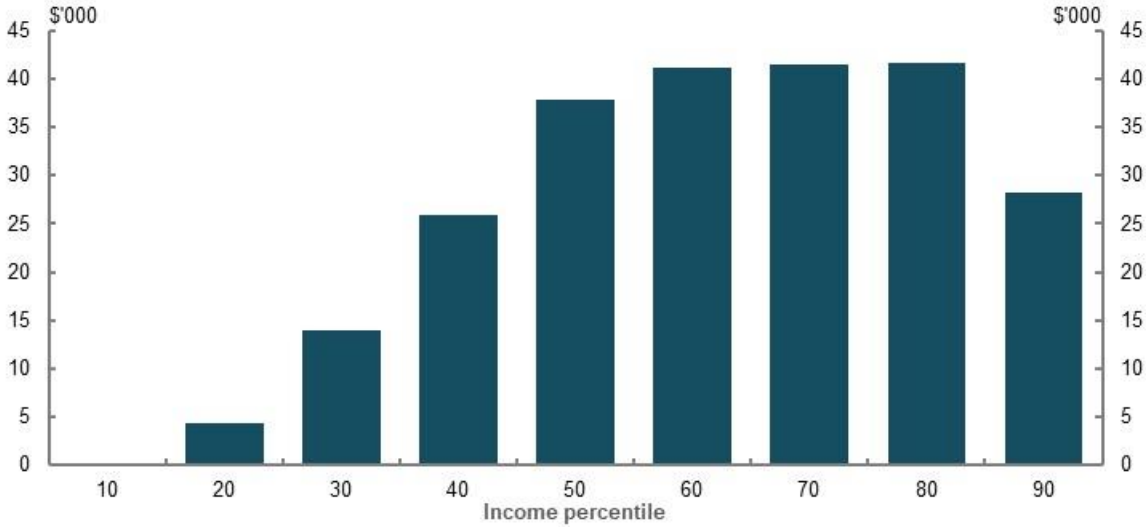


Note: Thresholds are for couples who are home owners as at June 2017. Assessable assets defined in the Survey of Income and Housing as household wealth less value of the home. Source: Analysis of ABS Survey of Income and Housing Confidentialised Unit Record File, 2017-18.

Long-term impact on retirement income

As the superannuation system matures, future retirees will have higher assets in retirement. As a result, an increasing proportion of future retirees are likely to be affected by the assets test for at least some of their retirement. A lower taper rate would benefit retirees further down the income distribution range. By 2060, only people in the lowest 10 per cent of incomes would not benefit from a lower taper rate (Chart 5B-2).

Chart 5B-2 Projected change in total Age Pension received under a $2.25 taper rate



Note: Values are in 2019-20 dollars, deflated using the review's mixed deflator. Higher-income earners benefit from the lower taper rate because they draw down their assets to levels that make them eligible for a part-rate Age Pension as they age (see *Appendix 6A. Detailed modelling methods and assumptions)*. Source: Cameo modelling undertaken for the review.

Nevertheless, most of the benefit of a lower taper rate would go to middle- to higher-income retirees. A lower taper rate would increase eligibility for retirees with higher assets and increase income for retirees who receive part-pensions.

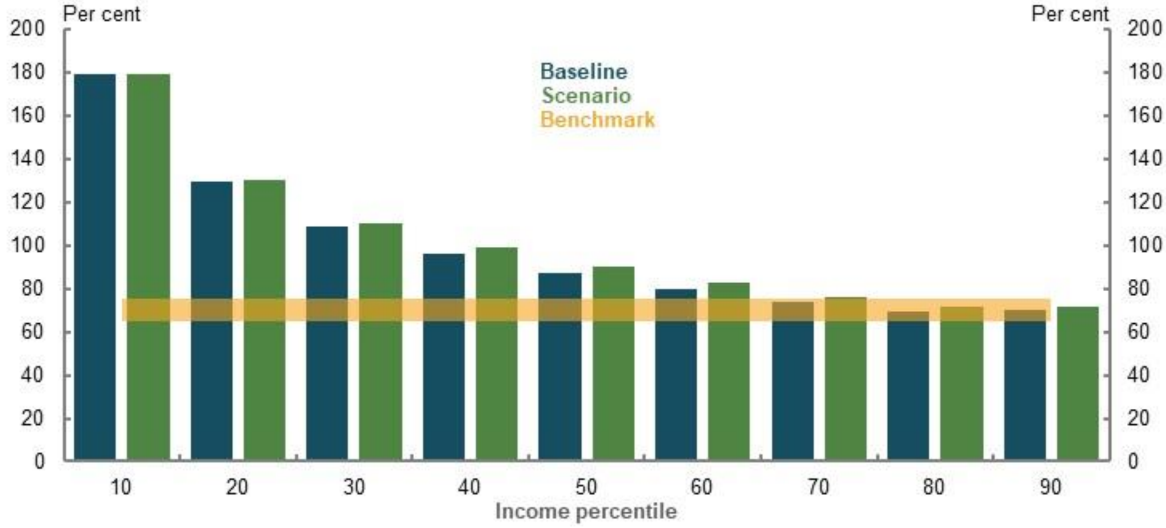
Retirees at the 60th to 80th income percentiles would see the largest increases in lifetime Age Pension payments from a lower taper rate. Since people in these percentiles spend more time than others in retirement receiving part-pensions, they would be most affected by a taper rate change.

For example, a retiree at the 60th percentile would receive no income from the pension when they began their retirement. Depending on the extent they draw down their assets, under a lower taper rate they would become eligible for a part-pension at an earlier age. The benefit of a lower taper rate is smaller for retirees whose assets drop below the assets test threshold earlier in retirement and, consequently, spend fewer years affected by the assets test.

Replacement rates

It is estimated that a $2.25 taper rate would increase replacement rates for most income percentiles, primarily due to higher Age Pension payments (Chart 5B-3). **The improvement would be largest for middle-income retirees** (40th to 70th percentiles), with replacement rates for the median-income retiree improving by around 3 percentage points. As middle-income retirees spend a significant portion of their retirement accessing a part-rate Age Pension, they are particularly affected by a change in means testing.

Chart 5B-3 Projected replacement rates for retirees by income percentile



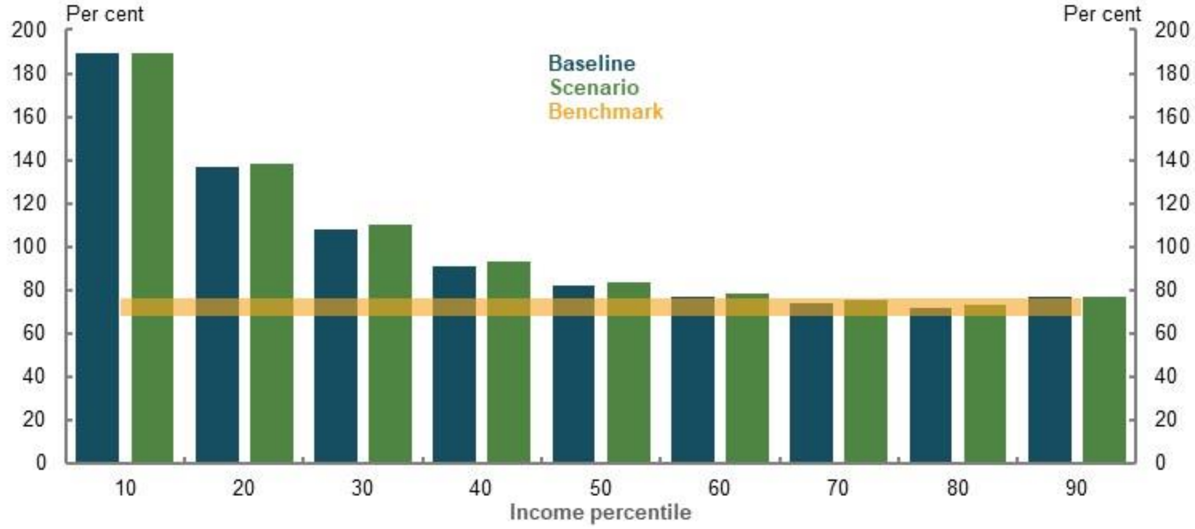
Source: Cameo modelling undertaken for the review.

For the 60th percentile and below, the increase would result in replacement rates further exceeding the 65-75 per cent benchmark for replacement rates (see *2C. Maintaining standards of living in retirement*). This suggests the change is not needed for these retirees to achieve an adequate retirement income.

Lower-income retirees (30th percentile and under) would mostly be unaffected by the taper rate change. This group does not accumulate enough assets to be affected by means testing for most of their retirement. Higher-income retirees would see very little change in their replacement rates, as Age Pension payments are low compared with their retirement income. The high asset values for this group mean they do not access the Age Pension for significant portions of their retirement.

The assets test taper rate change would affect couples differently to singles. For couples, the taper rate changes increase replacement rates at lower-income deciles (Chart 5B-4).

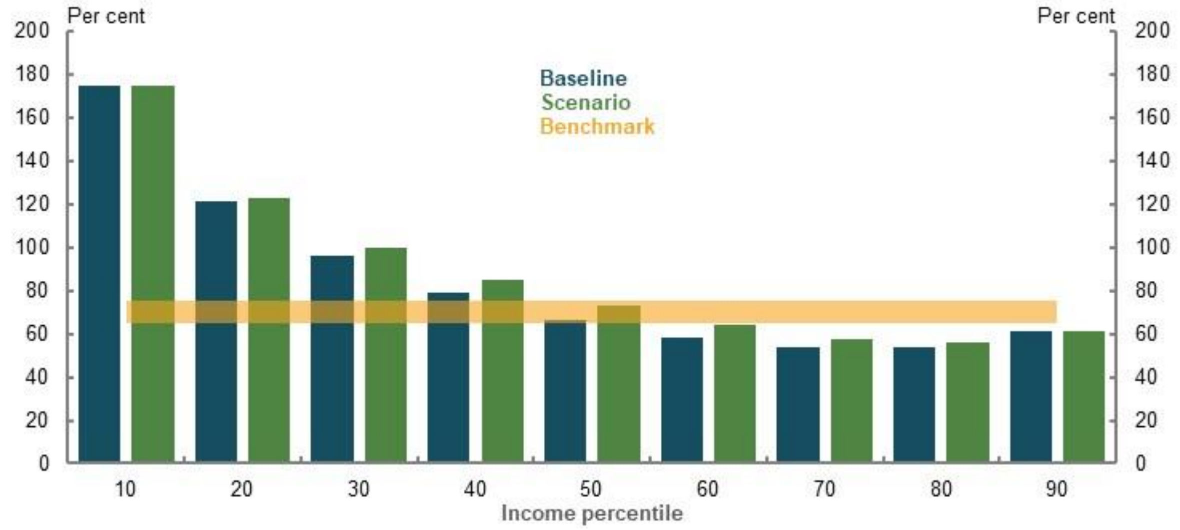
Chart 5B-4 Projected replacement rates for coupled retirees by income percentile



Source: Cameo modelling undertaken for the review.

The analysis for both singles and couples assumes that retirees efficiently draw down their assets in retirement (*Appendix 6A. Detailed modelling methods and assumptions)*. If drawdowns were instead at legislated minimum rates, the taper rate change would provide a larger increase in replacement rates for middle-income earners. Under lower drawdown rates, middle-income retirees maintain higher asset values for longer and therefore spend more of their retirement affected by means testing (Chart 5B-5).

Chart 5B-5 Projected replacement rate when assuming minimum drawdowns for retirees by income percentile



Source: Cameo modelling undertaken for the review.

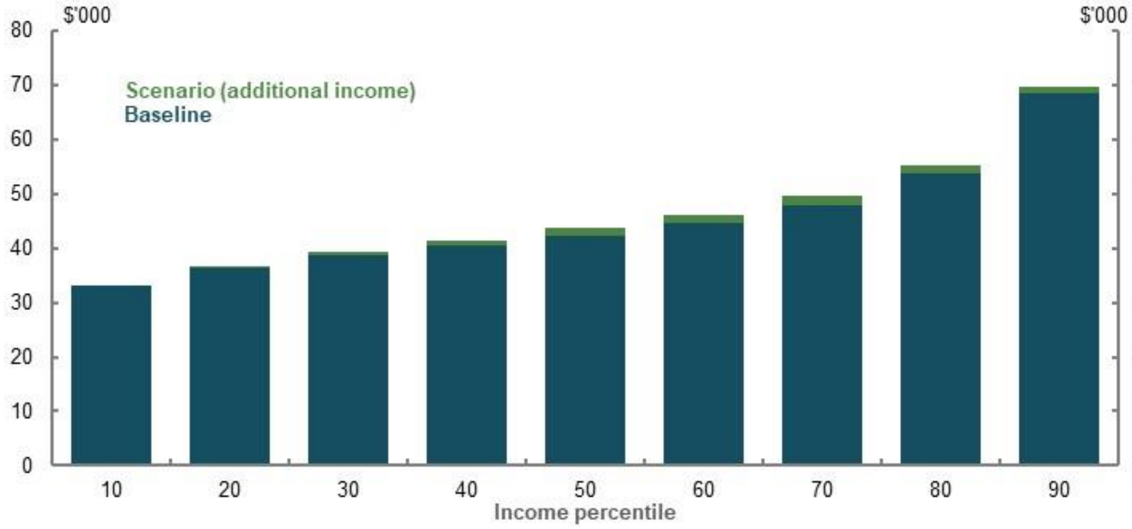
Effect on equity

Income equality in retirement

A lower taper rate would have a small effect on income inequality. It would decrease the retirement income gap between middle- and higher-income retirees, and increase the retirement income gap between lower-income retirees and all other retirees.

The magnitude of these changes would be small (Chart 5B-6). For example, currently retirees in the 90th income percentile are projected to have incomes 1.63 times that of median-income retirees. With the lower taper this would reduce to 1.60.

Chart 5B-6 Projected average annual income of retirees by income percentile

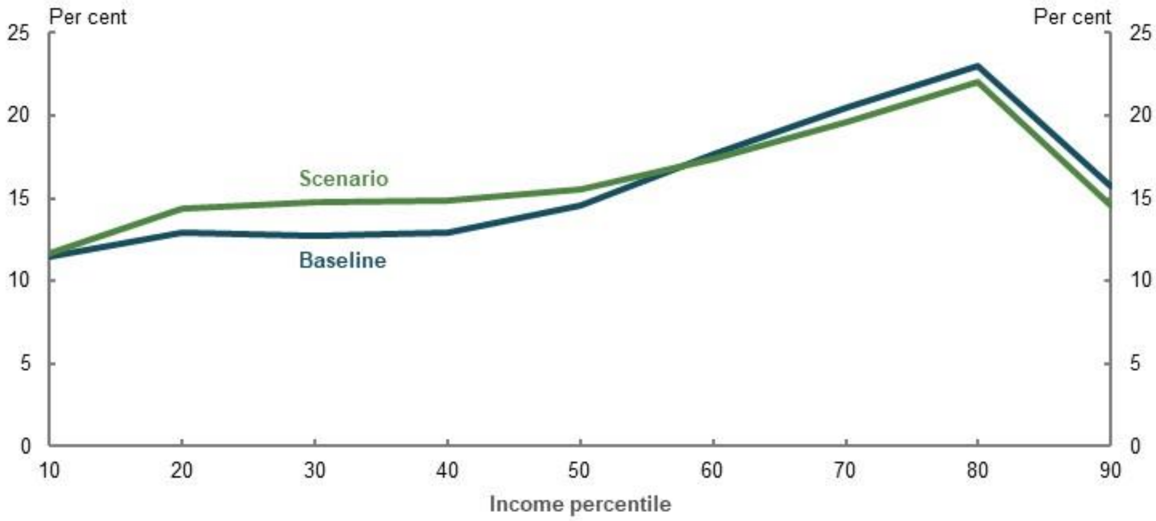


Note: Values are in 2019-20 dollars, deflated using the review's mixed deflator. Source: Cameo modelling undertaken for the review.

Groups that would benefit less from a lower taper rate

A lower taper rate would increase the gender gap in retirement incomes at the lower end of the income distribution (Chart 5B-7). This is because men at lower percentiles receive an asset-tested rate of Age Pension for more of their retirement than women, benefiting more from a lower taper rate. In comparison, at higher percentiles, a lower taper rate would marginally narrow the gender gap in retirement incomes. Men spend more time than women not receiving any Age Pension and would therefore benefit less from the change.

Chart 5B-7 Projected effect of a taper rate change on the gender gap in annual average retirement incomes



Note: Gender gaps are calculated relative to men's retirement incomes. A 10 per cent gender gap in retirement incomes means that women's incomes are 90 per cent of men's incomes. For more detail on the adjustments to the cameo model for gender analysis, see *Appendix 6A. Detailed modelling methods and assumptions.* Source: Cameo modelling undertaken for the review.

Under the scenario assessed, the median woman would receive a 2.5 per cent increase in average annual retirement income from a lower taper rate, compared to the 3.7 per cent increase in average annual retirement income received by the median man.

Other groups that are disproportionately represented among low-wealth retirees would benefit less from a lower taper rate. These groups include early retired households, Aboriginal and Torres Strait Islanders people and people with disabilities.

Effect on sustainability

Fiscal cost

Lowering the taper rate would come with a fiscal cost. For example, the fiscal cost of lowering the taper rate to $2.25 in 2019-20 would be around $1 billion (0.05 per cent of GDP). This is projected to grow to 0.1 per cent of GDP in 2029-30 and 0.2 per cent of GDP in 2059-60 as the superannuation system matures and households accumulate more assets (Table 5B-2).

Table 5B-2 Indicative fiscal costs of reducing the assets test taper rate to $2.25

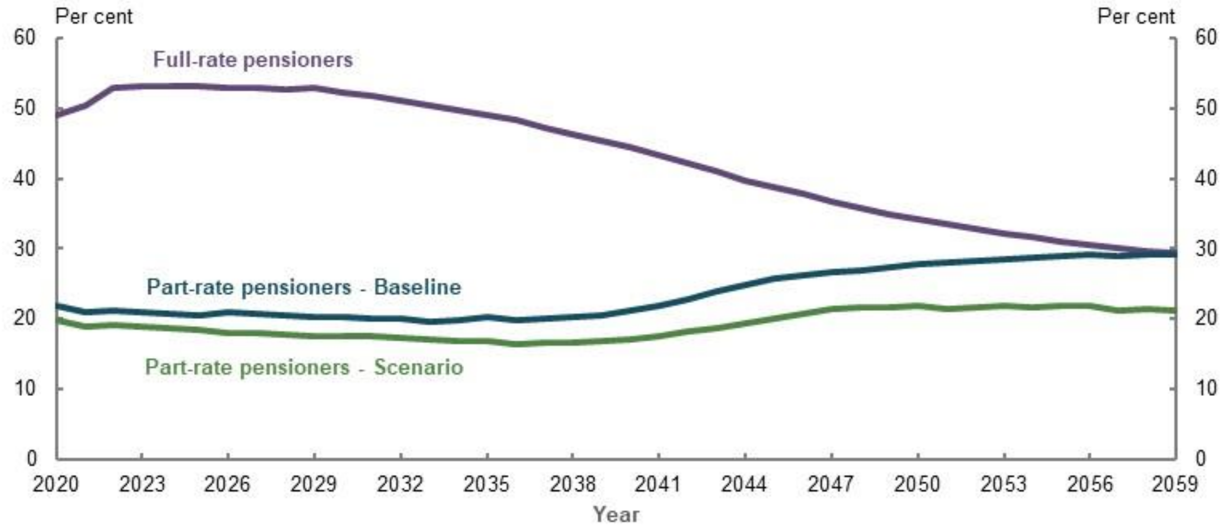
	2019-20	2029-30	2039-40	2049-50	2059-60
Total cost (per cent of GDP)	0.05 (about $1 billion)	0.10	0.12	0.17	0.20

Note: This is a counterfactual analysis as if the Age Pension assets test taper rate was reduced from 1 July 2019. Source: Department Social Services modelling for the review and analysis of Rice Warner estimates for the review.

The increased cost is due to higher Age Pension payments. More retirees would become eligible to receive a part-pension, and many would receive higher pension payments. The change would result in an increase of 8 percentage points in the proportion of people receiving a part-rate Age Pension by 2059-60 from around 21 per cent to around 29 per cent (Chart 5B-8).

If the free area of the assets test was unchanged, lowering the taper rate would have a negligible effect on the number of retirees receiving a full-rate Age Pension.

Chart 5B-8 Projected proportion of retirees on a full- and part-rate Age Pension



Source: Analysis of Rice Warner estimates for the review.

Effect on cohesion

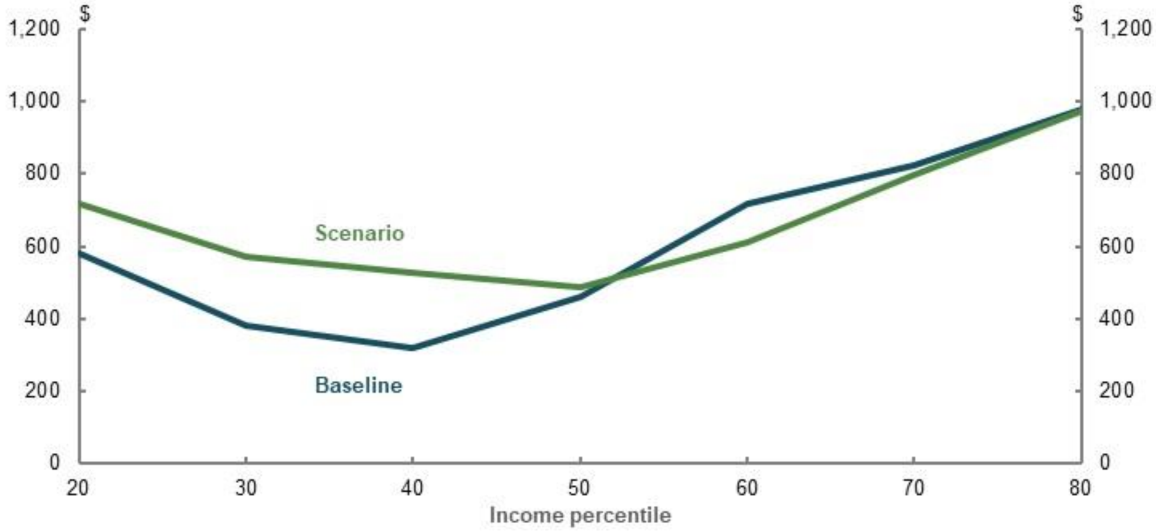
Incentives to save

Lowering the taper rate would increase the marginal benefit from saving for the 20th to 40th percentiles (Chart 5B-9). These income groups would see a smaller reduction in their pension due to the increase in their assets. For the 50th percentile and above, the lower taper rate would have little effect on their return on saving.[321]

While improving incentives to save for some, a lower taper rate may not meaningfully affect savings behaviour because:

- Even though the return from marginal savings improves, effective marginal tax rates on retirement savings remain high, maintaining the disincentive to save. Even with a taper rate as low as $1, the retirement income generated by saving $1,000 prior to retirement remains less than $1,000 of retirement income.
- Many people of working age are not aware of or do not understand the assets test (see *5A. Cohesion*). Savings behaviour may not be affected if people do not understand the benefits and take them into account.
- Behavioural economics research suggests reactions to incentives are smaller when the effects are less noticeable (Varela, 2016). In the pre-retirement phase, people may not take into account the effect of the taper since it occurs many years in the future.

Chart 5B-9 Projected effect of saving an extra $1,000 immediately before retirement, by income percentile



Note: The scenario assumes people salary sacrifice an additional $1,000 in the year before retirement. Superannuation is drawn down at an annuitised rate to life expectancy. The 10th income percentile is excluded from this analysis due to low asset levels in superannuation and relatively low marginal propensity to save. The 90th percentile is excluded because their projected balance is already over the transfer balance cap, and so cannot make post-tax voluntary contributions. Total retirement income and components are deflated by CPI. Source: Cameo modelling undertaken for the review.

[321] The incentive to save would be actually slightly worse for the 60th percentile and above. The lower taper rate means these income groups spend more of their retirement subject to means testing and therefore lose more of the marginal $1,000 due to lower pension payments. The marginal effect of saving an extra $1,000 should not be confused with the overall increase in income that the lower taper rate delivers to these groups. All receive more income overall with a lower taper rate (Chart 5B-2).

Asset drawdowns

As outlined in *2C. Maintaining standards of living in retirement*, improving retirees' drawdowns of their superannuation assets, along with accessing the equity in their home, can significantly increase their retirement incomes.

Many retirees currently draw down their assets at low rates. This likely reflects fear of outliving their savings; saving for unexpected expenses in retirement; and relying on the statutory minimum draw down rates as a default (see *5A. Cohesion*). Addressing these issues directly, including promoting greater understanding of the retirement system and broader availability of products, would help people use their assets more efficiently in retirement. It would reduce the incentive for retirees to draw down by:

- Providing higher pension payments for a given level of assets
- Increasing eligibility for a part-pension at higher incomes

In particular, a lower taper rate would give more income to middle-income retirees drawing down at the minimum rate, reducing the need to draw down their assets to support their retirement income. However, the primary drivers of drawdown rates appear to be unrelated to the taper rate, so the effect of changing the rate may be small (see *5A. Cohesion*).

Merged means test

Submissions raised a series of approaches to redesign and simplify the means test arrangements. These included:

- **A universal age pension**. This would require a fundamental redesign of the retirement income system, including superannuation tax concessions
- **Merging the income and assets tests**. This was raised in submissions and past reviews

Between 1961 and 1976, Australia had a merged means test. The test reduced annual pension payments by the amount of any deemed income derived from property above an exempt amount, as well as by the amount of any income not derived from property. The merged means test was effectively abolished in 1976 when reform was introduced to make the means test an 'income-only' test. In 1985, assets test components were reintroduced to the means test to address fiscal pressures and ensure the Age Pension was appropriately targeted.

The final reports of (Australia's Future Tax System Review, 2009) and (National Commission of Audit, 2014) recommended simplifying the dual means test by abolishing the assets test. In its place, they recommended introducing a single comprehensive income test that would deem income from a greater range of assets, including a proportion of the family home above a certain threshold.

In contrast, other stakeholders have proposed a merged means test by 'combining' the income and assets tests (e.g. Centre for Law, Markets and Regulation (2020) and Andrew Podger (2019)). Such a combined means test would include an asset capital drawdown component (in place of the assets test) to recognise that a person can draw down on their assets to provide retirement income.

Issues with the current dual means test

Stakeholders highlighted that the dual means test is complex. The complexity makes it difficult for retirees to understand how each test assesses their income and assets, and the interactions between the income and assets tests taper rates, thresholds and Age Pension payment rate. This also makes it difficult for retirees to navigate the retirement income system.

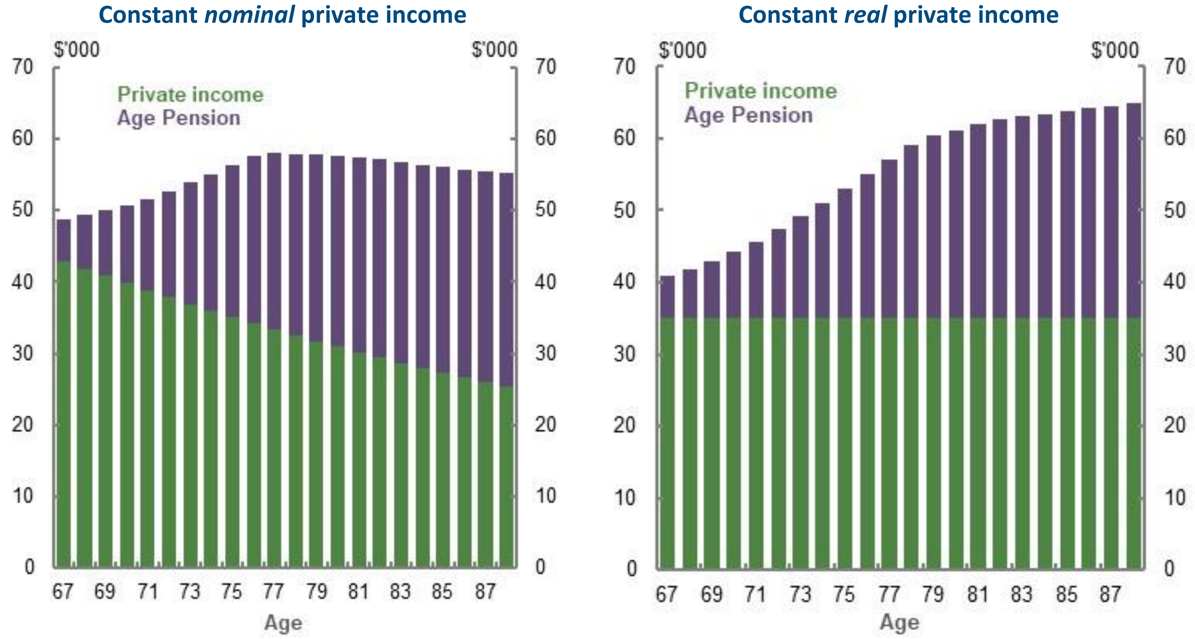
The dual means test can result in inequitable outcomes (Australia's Future Tax System Review, 2009) as people with different levels of means can receive the same Age Pension income in some circumstances. This is because when the assets test determines a retiree's Age Pension payment amount, their income (such as from part-time work) does not affect their Age Pension payment amount. Similarly, when the income test determines a retiree's Age Pension payment amount, the value of a retiree's assets does not affect their Age Pension payment amount.

Under the dual means test, people on a part-rate Age Pension typically receive substantially higher Age Pension payments later in their life (over and above the effects of indexation). This makes it difficult for people to derive stable incomes when combining their Age Pension and income from superannuation or other private sources.

This instability in incomes occurs under a range of drawdown strategies, including when a person takes up an account-based pension and draws down to have constant private income in nominal or real teams (Chart 5B-10), or draws down according to the superannuation minimum drawdown requirements (see *Section 5A. Cohesion*). For example, a 67-year-old single home owner with $500,000 of assessable assets, who uses an account-based pension to deliver constant private income in nominal terms, will see their Age Pension payment increase by more than 400 per cent from less than $10,000 to $30,000 at age 87.

These profiles of retirement income do not align with observed patterns of retiree consumption, which decline through retirement, partly because health and aged care are heavily subsidised by Government (see *5A. Cohesion*). Under current arrangements, the profile of the Age Pension makes it difficult for people on a part-rate Age Pension to achieve a broadly constant level of total income in retirement in real terms or in nominal terms (Chart 5B-10).

Chart 5B-10 Age Pension and private income in retirement for $500,000 of assessable assets under the current arrangements, by age



Note: Values are in 2019-20 dollars, deflated by CPI. Assumes the person is a single home owner who begins retirement on 1 July 2019. Constant nominal private income means the person consumes $43,000 of their assessable assets each year. Constant real private income means the person consumes $35,000 of their assessable assets at age 67, with the amount consumed increasing by 2.5 per cent (i.e. inflation) each year. The person has around $10,000 of assessable assets remaining at age 88 under both drawdown strategies. Source: Calculations based on Age Pension rates and thresholds as at 1 May 2020 and assumptions for the example of a merged means test. The life expectancy used to calculate the deemed capital consumption is sourced from the Australian Life Tables 2015-17 (Australian Government Actuary, 2019).

Trade-offs involved in merging the income and assets tests

Merging the current income and assets tests would represent a fundamental change to the way entitlement to the Age Pension is determined. The design of a merged means test would involve trade-offs between different aspects of the retirement system objective. It would be challenging to design a merged means test that achieves all the suggested elements of the objective for the retirement income system — particularly equity and cohesion.

For example, the proposal by Australia's Future Tax System Review (2009) and the National Commission of Audit (2014) would significantly simplify the current dual means test. But abolishing the assets test would not fully reflect the objective of the current dual test to target Age Pension payments. It would result in means from assets being assessed only in terms of earnings they could generate, and not on the ability to draw on the capital itself.

Such a change would have adverse equity implications. It would likely involve a **large fiscal cost**. In addition, assessing retirees' means by using only the income from their assets implies the objective is for retirees to maintain their assets through retirement, consuming only their income, rather than drawing on the capital itself.

One way a merged means test could achieve the intent of the assets test would be to include a capital consumption component in the income test. This would effectively assess retirees' means by assuming they are drawing down on their assets to fund their retirement and would overcome some of the equity challenges of applying an 'income-only' test. This approach could also generate more stable Age Pension income across retirement for some retirees. However, this would likely require the amount assumed to be drawn down be determined by remaining life expectancy and so vary by age, as suggested in the submission by the Centre for Law, Markets and Regulation (2020).

Such an approach is likely to be complex and difficult for retirees to understand and apply, and could result in reduced transparency compared with current arrangements. Depending on design, it could raise concerns as it may result in some people on a part-rate Age Pension receiving less than they currently do. Being quite different from current arrangements may necessitate the use of transitional arrangements to avoid making some existing retirees worse off. Such arrangements would add complexity to the means test, requiring two schemes to operate simultaneously for an extended period.

A merged means test could be designed to improve some elements of the retirement system objective but it would be difficult to avoid compromising others. Ultimately, the impact of a merged means test would depend on the selected policy parameters, such as the model for assessing assets, how assets are assumed to contribute to means, the level of means a person can have without reducing their Age Pension, and the rate at which support is withdrawn.

An illustrative example of a merged means test is investigated in *Appendix 6B. An example to illustrate the trade-offs of merging the income and assets tests*. It provides evidence on the trade-offs involved in a merged means test. It does not represent an ideal or preferred approach.