

**Australia's future tax system**  
**The retirement income system:**

Report on strategic issues

May 2009

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4 May, 2009

The Hon Wayne Swan MP  
Treasurer  
Parliament House  
CANBERRA ACT 2600

Dear Treasurer

### **REPORT ON STRATEGIC ISSUES FOR THE RETIREMENT INCOME SYSTEM**

I am pleased to present to you the report of Australia's Future Tax System Review Panel on the retirement income system. The report presents the Panel's broad strategic views of the retirement income system. The Panel's views have been informed by the findings of the Pension Review undertaken by Dr Harmer.

The Panel's key finding is that the three-pillar architecture of Australia's retirement income system should be retained. The retirement income system is facing increasing challenges as the 21st century unfolds. These challenges will test the sustainability, adequacy, acceptability and coherence of the system. The three-pillar architecture is well positioned for a balanced and flexible response to these challenges.

However, there is a need for some adaptive change to calibrate the three pillars so that the retirement income system serves its purposes and retains its strengths. The Panel recommends:

- maintaining the superannuation guarantee at 9 per cent, not extending the superannuation guarantee to the self-employed and retaining the \$450 per month threshold;
- gradually increasing the Age Pension age to 67 years; and
- gradually aligning the age at which people can access their superannuation savings (the preservation age) with the increased Age Pension age.

The Panel also makes the following in-principle recommendations, with final recommendations to be included in the December report:

- improving the fairness and coherence of the existing pension means tests, possibly through a single test, and improving incentives to work beyond retirement age;
- reducing the complexities resulting from the interactions between the tax-transfer system and the aged care sector;
- maintaining tax assistance to superannuation but improving the fairness of concessions for contributions, including by broadening access to them and limiting generous salary-sacrifice concessions;

- improving the ability of people to use their superannuation to manage longevity risk; and
- improving the awareness and engagement of individuals with the retirement income system.

I commend the report to you.

Yours sincerely

Ken Henry  
Chair  
Review Panel  
Australia's Future Taxation System

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# Summary of findings and recommendations

## Findings

1. The key finding of the Panel is that the three-pillar architecture of Australia's retirement income system, consisting of the means tested Age Pension, compulsory saving through the superannuation guarantee and voluntary saving for retirement, should be retained.

The retirement income system is facing increasing challenges as the 21st century unfolds. Some are relatively clear to us, including the ageing of the population, longer life expectancies and the fact that many more people will interact with the system. Others are less clear, arising from the diverse range of risks and uncertainties about future economic, social and environmental circumstances faced by all. These challenges will test the sustainability, adequacy, acceptability and coherence of the system, but the three-pillar architecture is well suited for a balanced and flexible response.

The three-pillar system has strong community support. The five objectives of the system outlined in the *Retirement income consultation paper* released in December 2008 – adequacy, acceptability, robustness, simplicity and sustainability – inevitably involve tradeoffs. The present three-pillar architecture broadly addresses these objectives in a reasonable, balanced way. Critically, it also provides flexibility, adaptability and sharing of risk to face the challenges ahead. Consequently, the Panel is proposing a range of improvements to the present system, rather than wholesale redesign.

2. The three-pillar architecture should be founded on the presumption that the responsibility for providing for retirement is shared between government and individuals. Governments should provide for minimum and essential needs and facilitate self-provision. Each of these goals should be pursued in an equitable and targeted way. Individuals should save or insure during their working lives to provide resources in their retirement. Inevitably under this approach, retirement outcomes will differ for different people, depending on the extent to which they can and do make self-provision.

The objectives of each of the three pillars should be as follows:

(a) The means tested Age Pension should ensure that all Australians receive a safety net level of income throughout their retirement that is adequate to provide a reasonable minimum standard of living. The question of Age Pension adequacy has been addressed in the Pension Review and is not considered further in this report.

(b) Compulsory superannuation should ensure that a reasonable minimum share of employee income is saved to contribute additional resources to retirement. Because it is a defined contributions system, rather than defined benefits system, it is not appropriate or practicable to set a target replacement income rate for the superannuation guarantee. However, the rate of the superannuation guarantee can be benchmarked by reference to moderate potential replacement rates for retirees with a full history of contribution at median to average earnings.

(c) Voluntary superannuation should provide a tax-assisted means for all to make self-provision for retirement in accordance with their circumstances and preferences. For reasons of both acceptability and sustainability, the extent of tax assistance should be capped.

3. There is a need and an opportunity to calibrate the three-pillar architecture to meet better the future challenges, and to reform some structural weaknesses within the system. However, reflecting the fact that the retirement income system is one part of the broader tax-transfer system, the Panel's final recommendations on some of these opportunities will depend on its assessment of that broader system.

### Recommendations for system design

1. The superannuation guarantee rate should remain at 9 per cent. The Panel has considered carefully submissions proposing an increase in the superannuation guarantee rate. Such an increase could be expected to lift the retirement incomes of most workers. However, the Panel considers the rate of compulsory saving to be adequate. The Age Pension and the 9 per cent superannuation guarantee (when mature) can be expected to provide the opportunity for people on low to average wages with an average working life of 35 years to have a substantial replacement of their income, well above that provided by the Age Pension. This strikes an appropriate balance for most individuals between their consumption opportunities during their working life and compulsory saving for retirement. The Panel considers that more can be done through preservation and other rules to ensure that the 9 per cent contribution rate produces an adequate retirement income for greater numbers of people, and its other recommendations are made partly for this purpose. For higher income workers especially, the third pillar provides an opportunity to access significantly higher income replacement rates.

2. The superannuation guarantee broadly should continue to cover employees. While those who derive business income should make provision for their retirement during their working lives, the diverse and varying risks and circumstances of business and entrepreneurship argue for allowing full flexibility in their saving and investment decisions. The voluntary superannuation system is available to small business people for contributing to meeting their retirement needs. However, there can be a fine line between those who are self-employed and those who are performing contracted duties similar to an employee. This distinction arises in a number of areas of policy. In its final report, the Panel will consider further how to distinguish the self-employed, including whether the scope of the superannuation guarantee could be extended to include with greater clarity and certainty arrangements that are close in nature to a formal employer-employee relationship. The \$450 per month threshold should continue to apply, as the compliance costs to the employer of providing superannuation guarantee contributions to marginally attached workers are outweighed by the benefits to the employee.

3. Australia's retirement income arrangements should be adjusted to respond to increasing life expectancies. This would enhance the acceptability, adequacy and sustainability of the retirement income system. Increasing life expectancies mean that: people are spending more time in retirement relative to working life; savings during working life are less able to meet retirement needs; and aggregate budgetary costs of the Age Pension are increasing. While provision must continue to be made for those who are required to retire at earlier ages, the general age for access to the Age Pension and for access to preserved superannuation benefits should be increased.

The eligibility age for the Age Pension should be increased to 67 years. This should be done gradually to give people time to adjust to the changes. The increase in the Age Pension age should be part of a suite of policies aimed at increasing the workforce participation of older Australians. It is proposed that the current five year difference between eligibility for the Age Pension and the Service Pension remain.

The general access age for superannuation benefits should also increase to 67 years. This would enhance the outcomes from the superannuation guarantee and improve the coherence of the system by strengthening the integration between the Age Pension and superannuation components of the retirement income system. The Panel's final report will explore further some associated issues such as the treatment of occupations with mandatory retirement ages and Service Pensioners.

A review should be undertaken by 2020 to consider whether it is appropriate to increase retirement ages further in later years.

4. There is a case for reforms to improve the fairness and coherence of Age Pension means tests through a single means test that removes the assets test and extends the income test by deeming returns on a greater range of assets. A single means test has the potential to improve the fairness and coherence of the retirement income system. The design of the new test should await further consideration of the interaction between means tests and the personal income tax system. The broad intention is to find ways to simplify substantially the experience of part-rate pensioners in complying with the two systems, while also striking an appropriate balance between the targeting of pensions and maintaining incentives for work and saving. To encourage ongoing workforce participation, the new test should include concessional treatment of income from employment (relative to the treatment of other income). The new test should continue to recognise the special role of owner-occupied housing in retirement security and wellbeing.

5. The interaction of the tax-transfer system and the aged care system, particularly the means testing arrangements, needs to be explored further. The quality of life of older Australians is affected significantly by their access to and experience of age-related services, such as aged care and health. Future government spending on these services is projected to increase substantially. The Panel will give further consideration to a range of interactions between the tax-transfer system and other systems (such as the funding of housing assistance and health care). It will address the role of the tax-transfer system in funding aged care as part of that wider review in its final report.

6. The tax advantages provided for superannuation serve the dual purpose of providing incentives for contributions and delivering more neutral overall tax treatment of deferred consumption relative to current consumption. Current arrangements serve the second purpose effectively but some features do not provide fair or adequate incentives to all. Superannuation should continue to receive tax assistance, but there is a case for distributing assistance more equitably between high and low income individuals, including by limiting generous salary-sacrifice concessions. Similarly, everyone should have equitable access to the assistance. The Panel is undertaking a comprehensive review of the taxation treatment of saving and investment for its final report. Accordingly, it proposes to consider further the taxation treatment of superannuation saving as part of that wider assessment.



7. While superannuation generates assets for retirement, current arrangements do little to ensure that those assets can be used for income purposes throughout the years of retirement. As people live longer, there is a growing risk that individuals will exhaust their assets before they die. The lack of products that retirees can purchase to insure against longevity risk is a structural weakness in the system. Better retirement income products should be available for purchase so a person can ensure an income higher than the Age Pension throughout their retirement. A range of complex issues need to be addressed to deliver this outcome, including the scope for public and private provision, regulation and incentives to address market failures, and interactions with means tests and the tax system. The Panel proposes to give these issues further consideration in its final report.

8. The level of awareness and engagement of individuals with the retirement income system should be improved. There is evidence that a lack of awareness and engagement affects the coherence of the system and, potentially, its adequacy. Simpler arrangements, such as a single means test, can contribute to this task, but more needs to be done, particularly in building understanding of issues such as longevity risk. Government and the superannuation industry should share in the responsibility of assisting individuals to better understand and engage in the system.

# 1. Introduction

The retirement income system plays a critical role in redistributing income through individuals' lifetimes and between individuals, including across generations.

At the request of the Treasurer, the Panel has brought forward its consideration of the retirement income system so the Government can take into account these considerations in addressing pension adequacy in the 2009-10 Budget. The terms of reference for this review are at Appendix A.

In this advance report, the Panel presents its broad strategic views of the retirement income system. The Panel's views have been informed by the findings of the Pension Review undertaken by Dr Harmer.

The retirement income system is a key part of the broader tax-transfer system. A range of issues that were raised in consultations are not expressly dealt with in this report. They will be taken into account in the final report due in December 2009, as they should be considered in conjunction with the Panel's recommendations on the broader tax-transfer system. The Panel has not considered issues such as the system's prudential regulation, or product specific issues such as fees and charges, which lie outside its terms of reference.

The development of this report has taken place in the context of the global financial crisis which became evident in 2007 and has radically worsened since September 2008. This is a priority issue for governments around the world. This crisis significantly affected the economy and adversely affected actual and potential retirement incomes of many people. The global financial crisis presents an immediate challenge for many people in retirement and about to retire. It could change perceptions of the system, and preferences and conduct within it, even with a return of more stable investment conditions. The risks inherent in Australia's retirement income system and the need for its structure to be robust have been highlighted. In forming its views, the Panel has taken this into account, along with the longer term challenges facing the system.

The structure of the report is as follows:

- Section 2 describes the three-pillar architecture of Australia's retirement income system;
- Section 3 outlines the emerging pressures and ways that the system can be enhanced;
- Section 4 provides an assessment of the retirement income system against the objectives – broad and adequate, acceptable, robust, simple and approachable, and sustainable; and
- Sections 5 to 7 elaborate on three of the key recommendations for change in the report.

This report has been developed with the help of many people, in particular those who provided, at short notice, valuable submissions and/or participated in direct consultations with the Panel and the Secretariat. The public consultation meetings also offered valuable information on issues of concern to the community about the retirement income system. The

Panel records here its gratitude to all who have worked so diligently on this task, or taken time out to attend consultation meetings. Appendices B to E list the consultation questions and provide detail on the outcomes from the consultation process.

## 2. Australia's three-pillar system

### 2.1 Overall goals of the retirement income system

The *Retirement income consultation paper* (AFTS 2008) identifies five objectives of a retirement income system, namely:

- it should be *broad and adequate*, in that it protects those unable to save against poverty in their old-age and provides the means by which individuals must or can save for their retirement;
- it should be *acceptable* to individuals, in that it considers the income needs of individuals both before and after retirement, is equitable and does not bias inappropriately other saving decisions;<sup>1</sup>
- it should be *robust*, in that it deals appropriately with investment, inflation and longevity risk;
- it should be *simple and approachable*, in that it allows individuals to make decisions which are in their best interests; and
- it should be *sustainable*, in that it is financially sound and detracts as little as possible from economic growth.

These criteria are interconnected and need to be applied in a holistic manner when evaluating the performance of the retirement income system.

The *Retirement income consultation paper* sought feedback on these objectives. Most submissions support them, either explicitly or implicitly. There is particularly strong support for the proposition that the system should be adequate and sustainable.

Section 4 provides an assessment of the retirement income system against these objectives. It finds that the present three-pillar architecture broadly addresses these objectives in a reasonable, balanced way. The architecture also provides flexibility and sharing of risk to face the challenges of the substantial but uncertain economic and social changes of the 21st century and the impact of demographic change. However, tax concessions are not distributed equitably; there are insufficient products to insure against a person outliving their assets; and the system's complexity affects the individual experience of the retirement income system.

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<sup>1</sup> This paper uses the term 'saving' to refer to the act of adding to an individual's assets, and the term 'savings' to refer to the stock of those assets.

## 2.2 Australia's three-pillar retirement income system

Over the past 100 years, the retirement income system has evolved from one where the Age Pension primarily fulfilled a poverty alleviation function, to one where a combination of public and private provision meets a broad range of retirement income needs.

The three-pillar structure of the Australian retirement income system – the Age Pension, compulsory saving through the superannuation guarantee and voluntary superannuation saving – is unusual among developed countries, but it has considerable strengths.<sup>2</sup> In particular, it provides a system intended to satisfy the minimum needs of all Australians, provides the capacity for individuals to enhance their retirement income, and spreads risks between the public and private sectors in a fiscally responsible way.

Although the three pillars are described as one system, distinctions between the three pillars exist and are reflected in the form of the retirement benefit, the coverage of the three pillars, an individual's exposure to risk and whether a residual payment is made to a person's estate on their death. Table 2.1 summarises these differences.

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2 The retirement income system in many OECD countries provides a taxpayer or contribution funded retirement income based on a proportion of an individual's pre-retirement income. These countries also provide a minimum retirement income to alleviate poverty for those with a limited working life.

**Table 2.1: Characteristics of Australia's three pillar retirement income system**

	Form of benefit	Level of benefit	How funded	Coverage	Effective tax rate	Coverage of longevity, investment and inflation risk	Residual value at death
<b>Age Pension</b>	Income	Depends on marital status and subject to means tests	Current taxpayers	Universal <sup>(a)</sup> for a resident subject to means tests	Means tested based on income and assets. Subject to personal income tax with relief through offsets.	Yes, payable for life with wage indexation	No
<b>Superannuation guarantee</b>	An asset which can be converted to income	Depends on rate, salary/wage, returns and period in workforce	Employer contributions <sup>(b)</sup>	Employees, but upper cap on superannuation guarantee contributions exists. Exemptions also apply.	Flat 15 per cent on contributions and 15 per cent on earnings <sup>(c)</sup>	Depends on how people choose to take their benefit <sup>(d)</sup>	Yes
<b>Voluntary superannuation<sup>(e)</sup></b>	An asset which can be converted to income	Depends on amount invested and returns	Personal/employer contributions Government co-contribution if eligible	Work tests apply from age 65 years. The amount that can be contributed is capped.	Tax of 0 or 15 per cent depending on type of contribution, and 15 per cent on earnings <sup>(c)</sup>	Depends on how people choose to take their benefit <sup>(d)</sup>	Yes

(a) A person must be a resident for at least 10 years before becoming eligible for the Age Pension. However, there are rules which can provide for a shorter period.

(b) Although these contributions are made by the employer, the incidence is likely to fall on the employee through lower real wages.

(c) Benefits paid from a taxed superannuation fund to a person aged 60 years or older are tax-free. Earnings on assets supporting an income stream are tax exempt. Funds are eligible for imputation credits and a one-third capital gains tax reduction on assets held for at least 12 months.

(d) In principle, people can insure against these risks by purchasing an indexed lifetime annuity. The individual bears more risk with other types of income streams such as allocated pensions.

(e) Significant voluntary saving also occurs outside the superannuation system including owner-occupied housing, other property, financial assets and business assets.

## 2.3 The fiscal cost of the three-pillar architecture

The budgetary cost of the three-pillar architecture is influenced by a range of key policy parameters including: the level of the Age Pension; means testing of the Age Pension; the ages people can access the Age Pension and their superannuation; the rate of the superannuation guarantee; the taxation and other concessions provided to superannuation contributions; caps on contribution concessions; and the taxation of superannuation earnings.

Governments need to set these parameters on a long term basis to balance the requirements of adequacy and fiscal sustainability. Policy changes to vary any of these parameters will affect the long term work, consumption and saving decisions made by individuals over the course of their lifetime.

Adjustments to settings in the retirement income system should take account of these interactions across the broader system and reflect a long term strategic view about the structure of the system and its fiscal sustainability.

## 2.4 Retaining the existing three-pillar architecture

The strengths of the existing three-pillar system should be preserved. Not only does this system spread the responsibility and risk of providing retirement incomes in a fiscally sustainable way, it is also a structure that is likely to be durable and relevant across a broad range of economic, demographic and social outcomes.

Retirement arrangements involve very long term planning horizons and there is considerable merit in avoiding inessential large changes.

### The Age Pension

The means tested Age Pension is a particular strength of the system. Its purpose is to ensure that all Australians have access to a safety net level of income throughout their retirement that is adequate to provide a reasonable minimum standard of living. It substantially underpins the retirement incomes of most low to middle income earners. It supports people who live longer than expected and exhaust their private savings, and it supports those who have less than average full-time employment due to periods of unemployment, caring responsibilities, working part-time or spending part of their working life overseas. Being taxpayer-funded, the Age Pension provides protection against investment, inflation and longevity risk.

The Pension Review addressed separately the adequacy of the Age Pension.

### The superannuation guarantee

The superannuation guarantee was motivated to address a particular consequence of life-cycle 'myopia' – specifically, people not saving adequately for retirement because it is too far in the future for them to adequately 'see', and so make adequate provision for their needs. It is a private saving and asset accumulation vehicle that contributes to the improved

wellbeing of employees in retirement. It enables employees to achieve a level of retirement income above that provided by the Age Pension, with the extent of the increase affected, as for all savings, by the means tests. However, it does not apply universally; the individual bears some or all of the investment risk and there is no requirement that accumulated funds be applied to fund a retirement pension. Therefore, the superannuation guarantee has not been designed to support specific income replacement goals and, in the Panel's view, cannot be made to do so.

Even when mature (toward the end of the 2030s), the current rate of compulsory contribution by employers of 9 per cent will not be sufficient on its own to meet everyone's retirement income aspirations. However, together with the Age Pension, the superannuation guarantee is expected to provide the opportunity for people on low to average wages with an average working life of 35 years to have a substantial replacement of their income.

For example, on a set of assumptions detailed in Appendix F, as a consequence of the first and second pillars only, a worker on median income of 75 per cent of average weekly ordinary time earnings (AWOTE)<sup>3</sup> might be expected to have a replacement rate<sup>4</sup> of about 73 per cent. A worker on AWOTE might be expected to have a replacement rate of about 63 per cent.

Whilst obviously a matter for judgment, the Panel considers that, for most employees on low to middle incomes, the 9 per cent superannuation guarantee rate can provide a reasonable balance between before and after retirement incomes, at least insofar as compulsory arrangements should require. It is, of course, open to any individual to save more. In addition, adoption of the recommendations in this report and those of the Pension Review would have the effect of increasing the replacement rates achieved by the existing 9 per cent rate of compulsory superannuation saving.

Several submissions to the Panel have argued that replacement rates for low to middle income workers should be raised further. The Panel notes, in particular, the proposal in some submissions to increase the compulsory saving rate to 12 per cent (either through increasing the superannuation guarantee, mandatory employee contributions or a 'soft' compulsion arrangement). An increase in compulsory saving would increase potential retirement incomes. However, it would also reduce an employee's pre-retirement income. Low to middle income earners, who are typically unable to offset the impact of increased compulsory saving by reducing voluntary saving, could be expected to experience larger reductions in pre-retirement consumption opportunities than those experienced by higher income earners. For those who undertake other saving it would mandate a greater proportion of that saving in the form of superannuation. An increase in the superannuation guarantee would also have a net cost to government revenue even over the long term (that is, the loss of income tax revenue would not be replaced fully by an increase in superannuation tax collections or a reduction in Age Pension costs).

At higher levels of pre-retirement income, the Age Pension and the superannuation guarantee provide lower replacement rates. However, the retirement incomes of higher income workers provided by the Age Pension and the superannuation guarantee are higher

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<sup>3</sup> AWOTE is currently about \$60,000 per year with 75 per cent AWOTE about \$45,000.

<sup>4</sup> A replacement rate compares an individual's spending power before and after retirement (that is, after tax is paid). For example, a replacement rate of 75 per cent would mean that an individual would be able to spend in a given time period \$75 in retirement for each \$100 spent before retirement.



than those of lower income workers. For example, as a consequence of the first and second pillars only, a worker on AWOTE might be expected to have a disposable retirement income equivalent to about \$43,000 per year in today's dollars<sup>5</sup>; whereas, a worker on 2.5 times AWOTE might be expected to have a disposable retirement income equivalent to \$60,000 per year. There may well be a case for such a person seeking a higher retirement income, but the case for the government mandating that outcome is much less clear.

On average, employees on incomes of 2.5 times AWOTE contribute around an additional 10 per cent of their income to superannuation under the third pillar (through salary sacrifice arrangements), providing an expected income replacement rate of about 95 per cent when all three pillars are taken into account. Accordingly, the public policy case for insisting on higher levels of compulsory retirement saving for workers on above average incomes is relatively weak.

Some submissions have noted that older workers have not had the benefit of the superannuation guarantee for a full working life and could, as a consequence, have relatively low replacement rates. However, it is much less likely that older workers generally suffer from 'myopia' with respect to saving for retirement. Accordingly, the Panel does not consider that there is a public policy case for increasing the rate of compulsory saving of older workers.

The level of retirement incomes provided by the Age Pension and the superannuation guarantee would be increased further by adopting the recommendations in Section 3 to increase the age at which a person can access their superannuation, the recommendation to increase the Age Pension age, and any increase in pensions arising from the findings of the Pension Review.

The superannuation guarantee, since its inception, has not been applied to business income. The reluctance to extend the superannuation guarantee to small business recognises the diversity in the small business sector, its varying capital, liquidity and investment needs. While small business people and the self-employed should make provision for their retirement, the costs of compulsion may be higher in this sector than for employees. Many small business people have alternative strategies for saving for their retirement, often with different time profiles than those applying to employees. Including small business people would also be administratively difficult and add to the complexity of the system. Accordingly, the Panel recommends against extending the superannuation guarantee to small business people.

However, there can be a fine line between those who are self-employed and those who are performing duties similar to an employee. This issue arises in a number of areas of policy. The review will give further consideration to this issue in its final report, including whether there is scope and need to extend the superannuation guarantee to include with greater clarity and certainty, contractual arrangements that are close in nature to an employer-employee relationship.

Another exclusion from the superannuation guarantee system is for people earning less than \$450 per month. Several submissions propose that this threshold be abolished. However,

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5 Note that these projected disposable income estimates refer to a future year when AWOTE (even when discounted to today's dollars) will be considerably higher than the present level of \$60,000 because wages are projected to grow faster than prices.

there are significant differences in the type of work people may do and applying the superannuation guarantee from the first dollar of income may not be appropriate or cost-effective in many cases. The Panel is of the view that a simple threshold should continue to apply to ensure that the compliance costs to the employer of providing the contribution are outweighed by the benefits to the employee. On this basis, the current \$450 per month threshold provides an appropriate means of balancing these costs and benefits.

Many people have less than an average working life of 35 years of full-time employment due to periods of unemployment, caring responsibilities (in particular, women who may have a number of periods out of the workforce caring for others), working part-time or entering the workforce later than the average worker (for example, migrants). This affects the amount of compulsory superannuation savings they can expect to accumulate by the time they retire.

In the Panel's view, increasing the rate of the superannuation guarantee is an inappropriate way to increase the retirement savings of these groups. Like the self-employed, people who have an intermittent connection with the labour force are likely to prefer more liquid savings than superannuation. Support for people who have experienced broken work patterns should be achieved through the Age Pension.

### **Voluntary saving for retirement**

The third pillar of the retirement income system generally has been seen as the tax-assisted voluntary part of the superannuation system. Generous tax concessions encourage and assist those with saving capacity (including those not subject to the second pillar) to provide for their retirement.

The third pillar can also be viewed more broadly to include other forms of lifetime voluntary savings – owner-occupied housing, other property, financial assets and business assets. People on higher incomes are better able to save voluntarily through the third pillar and, on average, have similar replacement rates to people with lower pre-retirement incomes once these savings are taken into account.

## Recommendations

The superannuation guarantee rate should remain at 9 per cent. The Panel has considered carefully submissions proposing an increase in the superannuation guarantee rate. Such an increase could be expected to lift the retirement incomes of most workers. However, the Panel considers the rate of compulsory saving to be adequate. The Age Pension and the 9 per cent superannuation guarantee (when mature) can be expected to provide the opportunity for people on low to average wages with an average working life of 35 years to have a substantial replacement of their income, well above that provided by the Age Pension. This strikes an appropriate balance for most individuals between their consumption opportunities during their working life and compulsory saving for retirement. The Panel considers that more can be done through preservation and other rules to ensure that the 9 per cent contribution rate produces an adequate retirement income for greater numbers of people, and its other recommendations are made partly for this purpose. For higher income workers especially, the third pillar provides an opportunity to access significantly higher income replacement rates.

The superannuation guarantee broadly should continue to cover employees. While those who derive business income should make provision for their retirement during their working lives, the diverse and varying risks and circumstances of business and entrepreneurship argue for allowing full flexibility in their saving and investment decisions. The voluntary superannuation system is available to small business people for contributing to meeting their retirement needs. However, there can be a fine line between those who are self-employed and those who are performing contracted duties similar to an employee. This distinction arises in a number of areas of policy. In its final report, the Panel will consider further how to distinguish the self-employed, including whether the scope of the superannuation guarantee could be extended to include with greater clarity and certainty arrangements that are close in nature to a formal employer-employee relationship. The \$450 per month threshold should continue to apply, as the compliance costs to the employer of providing superannuation guarantee contributions to marginally attached workers are outweighed by the benefits to the employee.

## 3. Responding to emerging pressures by enhancing the system

### 3.1 Emerging pressures

While the existing broad architecture is supported, the retirement income system is facing a changing environment. Most of these changes occur gradually over time but can accumulate to a level requiring a response. They include:

- dramatic long term changes in Australia's demographic structure, with an increasing proportion of aged people and a declining proportion of working-age people;
- increasing life expectancies, leading to a longer average period in retirement and particularly strong growth in the number of people in the oldest age groups;
- advances in health technology that are improving the quality of life for many people with previously debilitating ailments;
- changing patterns of workforce engagement and labour mobility; and
- changing patterns of retirement, with sudden cessation of employment at a given age increasingly replaced by a longer and more flexible transition from work to retirement.

Collectively, these trends put increasing pressure on the retirement income system on three main fronts.

- **Sustainability.** For example, demographic change will impose increasing costs on government budgets, not only for retirement incomes but also for health and aged care services. Across governments, these increases are likely to exceed four per cent of GDP by the 2040s. Four per cent of GDP is equivalent to the revenue currently raised by the GST or the entire Australian Government health budget. Future taxpayers may therefore have to carry a higher taxation burden to support the funding of pensions, and other services, for a much larger population of retirees.
- **Adequacy and acceptability.** For example, longer periods in retirement increase the difficulty of relying on accumulated savings and, together with increasing numbers of the very old, ultimately increase considerably the reliance on the Age Pension. The distribution of concessions also influences the acceptability of the system.
- **System coherence** – that is system consistency, simplicity and transparency for individuals. For example, as Australia's three-pillar system matures more people will face the complexities of both the tax system and pension means tests (both assets-based and income-based). The impact of the means tests has changed considerably due to inflation, growth in household wealth and complexity, creating vulnerabilities for many people. While Australia's targeted assistance serves both sustainability and

fairness goals, a priority is to make it more coherent, consistent and easy to understand.

This review also provides an opportunity to address existing structural weaknesses in the system such as a lack of integration between the Age Pension and superannuation and the limited range of products a person can purchase to insure against the risk of exhausting their assets before they die, to make the system more robust.

## 3.2 Enhancing the system

These challenges and structural weaknesses lead the Panel to conclude that some adaptive changes will be necessary over the coming years to calibrate the system so it serves its purposes and retains its strengths. Policy change needs to be gradual to give people time to adapt.

The Panel recommends:

- gradually increasing the Age Pension age to 67 years;
- gradually aligning the age at which people can access their superannuation savings (the preservation age) with the increased Age Pension age;
- improving the fairness and coherence of the existing pension means tests, possibly through a single test, and improving incentives to work beyond retirement age;
- reducing the complexities resulting from the interactions between the tax-transfer system and the aged care sector;
- maintaining tax assistance to superannuation but improving the fairness of concessions for contributions, including by broadening access to them and limiting generous salary-sacrifice concessions;
- improving the ability of people to use their superannuation to manage longevity risk; and
- improving the awareness and engagement of individuals with the retirement income system.

Reflecting the need for many of these issues to be considered in the context of the overall design of the tax-transfer system, they will be the subject of further analysis by the Panel in developing its final report.

## 3.3 Access ages for the Age Pension and superannuation

The age at which pensions become available should be responsive to the increase in life expectancy and longevity. For a century, the Age Pension age has been 65 years for men. To support system sustainability, and fairness, and to ensure that social policies adapt to changes in the life circumstances of people, the Age Pension age should rise modestly and gradually to age 67 years. This would provide a strong social signal about work and retirement expectations and their link to increasing life expectancies. The increase in the

Age Pension age should be part of a suite of policies to increase the social and workforce participation of older Australians.

Consistent with the proposal to increase the Age Pension age, it is recommended that the preservation age gradually increase to age 67 years, with a view that it be aligned with the Age Pension age. This will enhance retirement incomes provided by the superannuation guarantee and improve the system's coherence by strengthening the integration between the Age Pension and superannuation.

In some circumstances, individuals have no choice but to retire early. Where they are not expected to be able to work again, it is appropriate they remain able to access their superannuation savings (and where applicable pension support). It is recommended that the current ability to take an income stream for life before preservation age continue, so that people can smooth their retirement income levels before and after preservation age.

The terms of reference require the Panel to have regard to the policy of tax-free superannuation from the legislated future preservation age at 60 years. The Government may wish to consider whether the age for tax-free superannuation should increase in line with future increases in the preservation age. Section 5 outlines the proposed changes to the Age Pension and preservation ages in more detail.

### Recommendations

Australia's retirement income arrangements should be adjusted to respond to increasing life expectancies. This would enhance the acceptability, adequacy and sustainability of the retirement income system. Increasing life expectancies mean that: people are spending more time in retirement relative to working life; savings during working life are less able to meet retirement needs; and aggregate budgetary costs of the Age Pension are increasing. While provision must continue to be made for those who are required to retire at earlier ages, the general age for access to the Age Pension and for access to preserved superannuation benefits should be increased.

The eligibility age for the Age Pension should be increased to 67 years. This should be done gradually to give people time to adjust to the changes. The increase in the Age Pension age should be part of a suite of policies aimed at increasing the workforce participation of older Australians. It is proposed that the current five year difference between eligibility for the Age Pension and the Service Pension remain.

The general access age for superannuation benefits should also increase to 67 years. This would enhance the outcomes from the superannuation guarantee and improve the coherence of the system by strengthening the integration between the Age Pension and superannuation components of the retirement income system. The Panel's final report will explore further some associated issues such as the treatment of occupations with mandatory retirement ages and Service Pensioners.

A review should be undertaken by 2020 to consider whether it is appropriate to increase retirement ages further in later years.

### 3.4 Older Australians and the tax-transfer system

Many older Australians interact with both the personal tax system and the Age Pension means tests. The complexity associated with these interactions places a substantial burden on older Australians. In its final report, the Panel will explore ways to improve the experience of older Australians engaging with the tax-transfer system. This may involve reducing the number of people who interact with both systems, making the system more seamless so people can deal with it in a single interaction or implementing a more integrated user interface.

The retirement income system and other tax and transfer arrangements are important in encouraging workforce participation and, consequently, in fostering system sustainability. Arrangements applying to the labour income of older Australians are likely to affect their work choices. The Panel will make recommendations that ensure appropriate incentives for workforce participation and skill formation for all Australians, including older Australians. For example, a concessional treatment of earned income in the Age Pension means test would improve incentives to work.

Means testing of pensions is an important tool for managing the sustainability of the retirement income system. However, some features of the current means tests influence choices about the form in which assets are held, resulting in an unequal treatment of pensioners with similar levels of private means. They also reduce coherence, partly because of increased complexity.

A single pension means test would have the potential to improve the integration of the retirement income system with the broader tax-transfer system. This could be achieved by eliminating the assets test and extending the income test by applying deeming to a broader range of assets. The Panel considers that a reformed means test would need to include concessional treatment of income from employment to improve incentives to work, and should continue to recognise the special nature of owner-occupied housing. Section 6 outlines an illustrative alternative means testing approach in more detail.

In addition to their retirement income, the quality of life of older Australians is affected significantly by their access to, and experience of, services such as aged care and health. Government spending on these services is projected to increase substantially in the future. It is important to consider how the tax-transfer system might best evolve to assist in meeting these rising costs.

The aged care sector is complex and makes many of the important decisions faced by older Australians unnecessarily difficult and their consequences highly uncertain. The National Health and Hospitals Reform Commission interim report (NHHRC 2008) identified some of these challenges, as well as potential reform directions.

Aged care support is means tested, and the means testing treatment varies according to the level of care provided. These interactions can affect the adequacy of the retirement income system.

In its final report, the Panel will consider the interactions between entitlements to aged care services and the broader tax-transfer system. It will undertake this review as part of a broader assessment of the role of the tax-transfer system in support of, and in interaction with, other social programs (such as those delivering housing assistance and financial support for health care).

## Recommendations

There is a case for reforms to improve the fairness and coherence of Age Pension means tests through a single means test that removes the assets test and extends the income test by deeming returns on a greater range of assets. A single means test has the potential to improve the fairness and coherence of the retirement income system. The design of the new test should await further consideration of the interaction between means tests and the personal income tax system. The broad intention is to find ways to simplify substantially the experience of part-rate pensioners in complying with the two systems, while also striking an appropriate balance between the targeting of pensions and maintaining incentives for work and saving. To encourage ongoing workforce participation, the new test should include concessional treatment of income from employment (relative to the treatment of other income). The new test should continue to recognise the special role of owner-occupied housing in retirement security and wellbeing.

The interaction of the tax-transfer system and the aged care system, particularly the means testing arrangements, needs to be explored further. The quality of life of older Australians is affected significantly by their access to and experience of age-related services, such as aged care and health. Future government spending on these services is projected to increase substantially. The Panel will give further consideration to a range of interactions between the tax-transfer system and other systems (such as the funding of housing assistance and health care). It will address the role of the tax-transfer system in funding aged care as part of that wider review in its final report.

## 3.5 Taxation of superannuation

Many submissions raise a concern that the superannuation taxation arrangements provide greater concessions to high income earners than low income earners. Assessing the equity of these arrangements solely on the interaction between the taxation of superannuation contributions and personal tax rates can be misleading. Any assessment should be done across the broader tax-transfer system.

The Panel's final report will review the tax treatment of superannuation as part of a wider assessment of all saving to ensure a coherent overall treatment. However, the Panel has formed in-principle views on some key elements of the treatment of superannuation savings.

- There is a general case for providing concessions under income tax arrangements for all forms of savings to reduce distortions in the relative treatment of current and deferred consumption. This case must usually be balanced against vertical equity considerations. Beyond this, reasons for favouring additional tax assistance for superannuation include the social benefits of overcoming life cycle myopia and compensating for compulsion and preservation.
- The distribution of the concessions is affected by a number of factors including income, age, access to income support and the level of contributions that a person makes. These factors mean the distribution of concessions for superannuation guarantee contributions is highly dependent on individual circumstances. Arrangements for voluntary superannuation contributions provide little or no concession for lower income earners (other than the superannuation co-contribution) and larger concessions



for higher income earners. In its final report, the Panel will consider options to distribute concessions more coherently and equitably across people with different income and circumstances.

- Access to tax assistance for contributions should not be limited by an employer's salary sacrifice policies, such that concessional treatment should apply to both salary sacrifice and personal contributions. However, there is a need to consider whether the current cap on the concessions available on contributions is appropriate.

Submissions also raise a number of specific tax-related issues including the age beyond which a person cannot make contributions, the taxation of benefits received by members of untaxed funds and the taxation of superannuation death benefits. These issues relate to the appropriate taxation of retirees and other savings. They will also be taken into account in the Panel's final report.

### Recommendations

The tax advantages provided for superannuation serve the dual purpose of providing incentives for contributions and delivering more neutral overall tax treatment of deferred consumption relative to current consumption. Current arrangements serve the second purpose effectively but some features do not provide fair or adequate incentives to all. Superannuation should continue to receive tax assistance, but there is a case for distributing assistance more equitably between high and low income individuals, including by limiting generous salary-sacrifice concessions. Similarly, everyone should have equitable access to the assistance. The Panel is undertaking a comprehensive review of the taxation treatment of saving and investment for its final report. Accordingly, it proposes to consider further the taxation treatment of superannuation saving as part of that wider assessment.

## 3.6 Use of superannuation benefits

Currently, individuals have considerable flexibility in their use of superannuation benefits. Given the very wide range of circumstances of retirees, this flexibility should continue to be available. However, the lack of products that guarantee an income over a person's retired life represents a structural weakness in the system. There is a strong case for new products to be developed and made available that would allow people to insure against the risk of exhausting their assets before they die.

While the Age Pension supports people when they exhaust their private assets, products that give people comfort that they will always have an income above the Age Pension would advance the financial security offered by the system. The Panel will undertake further research into whether these products should be delivered through the public or private sectors, or both. A range of other issues also need to be considered, including interaction with means tests. The Panel will also examine whether there should be a requirement for people to devote some part of their superannuation savings to the purchase of an income stream from the time of their retirement or, alternatively, a deferred income stream to support them in old age. Section 7 outlines issues in relation to these superannuation matters.

### Recommendations

While superannuation generates assets for retirement, current arrangements do little to ensure that those assets can be used for income purposes throughout the years of retirement. As people live longer, there is a growing risk that individuals will exhaust their assets before they die. The lack of products that retirees can purchase to insure against longevity risk is a structural weakness in the system. Better retirement income products should be available for purchase so a person can ensure an income higher than the Age Pension throughout their retirement. A range of complex issues need to be addressed to deliver this outcome, including the scope for public and private provision, regulation and incentives to address market failures, and interactions with means tests and the tax system. The Panel proposes to give these issues further consideration in its final report.

## 3.7 Awareness of the retirement income system

For many people, superannuation may be their first interaction with a financial product other than a bank account. People can remain disengaged from the system until they near retirement. This is because the decision to save is made for them through the superannuation guarantee, the choice of fund may be determined by their employer or an industrial agreement, and investment decisions are made by the fund trustee.

This lack of engagement may be contributing to the number of lost superannuation accounts. As at 30 June 2008, there were 6.4 million lost accounts, an increase of 300,000 accounts since 30 June 2007. There are approximately another 9 million inactive accounts.

### Recommendations

The level of awareness and engagement of individuals with the retirement income system should be improved. There is evidence that a lack of awareness and engagement affects the coherence of the system and, potentially, its adequacy. Simpler arrangements, such as a single means test, can contribute to this task, but more needs to be done, particularly in building understanding of issues such as longevity risk. Government and the superannuation industry should share in the responsibility of assisting individuals to better understand and engage in the system.

# 4. Assessment of the retirement income system

This section assesses the retirement income system against the five objectives outlined in Section 2.1 – broad and adequate, acceptable, robust, simple and approachable, and sustainable.

It presents information and data based on long run actuarial assumptions. It is important to note that specific groups of retirees will do better or worse than the projections in this section depending on factors such as workforce participation, labour income patterns, investment performance, inflation, longevity and whether an individual accesses their superannuation prior to Age Pension age.

## 4.1 Broad and adequate

In setting the minimum retirement income, the Age Pension plays an important role in the system. The Pension Review considered the adequacy of this payment.

The Age Pension will continue to contribute significantly to the retirement incomes of most Australians. About 80 per cent of people aged over 65 years receive some or all of the Age Pension. This is consistent with the then-Government’s views when it introduced the superannuation guarantee:

‘This Government sees the Age Pension not just as a security net for future retirees but as the keystone of its superannuation policies. It expects that most future retirees will continue to be eligible for the Age Pension (for example, through a part pension) which, with self-provided and tax-assisted superannuation, will allow a higher retirement income than is now generally available.’ (Australian Government 1992)

By way of illustration, the Age Pension will contribute significantly to the retirement income of a person who has a 35 year work history commencing in 2000. Table 4.1 shows that the Age Pension (on current policy settings) will provide over half the retirement income of a person who earns up to the average income, even after the superannuation guarantee matures. The Age Pension will also provide nearly a quarter of the retirement income of people earning 2.5 times AWOTE – noting, however, this illustration assumes that the person has only superannuation guarantee savings and no other assets or income, which would be unusual for most on higher incomes.

**Table 4.1: Contribution of the Age Pension to retirement incomes under a fully mature superannuation guarantee**

Income as a proportion of AWOTE <sup>(a)</sup>	Proportion of retirement income from the Age Pension (per cent)	Proportion of maximum rate of the Age Pension received (per cent)
0.75	62.7	94.5
1.00	54.0	88.8
1.50	40.0	76.5
2.50	23.5	55.2

(a) AWOTE is average weekly ordinary time earnings and is around \$1,150 per week (\$60,000 per year). Around half of workers earn less than three-quarters of AWOTE.  
Source: Treasury projections.

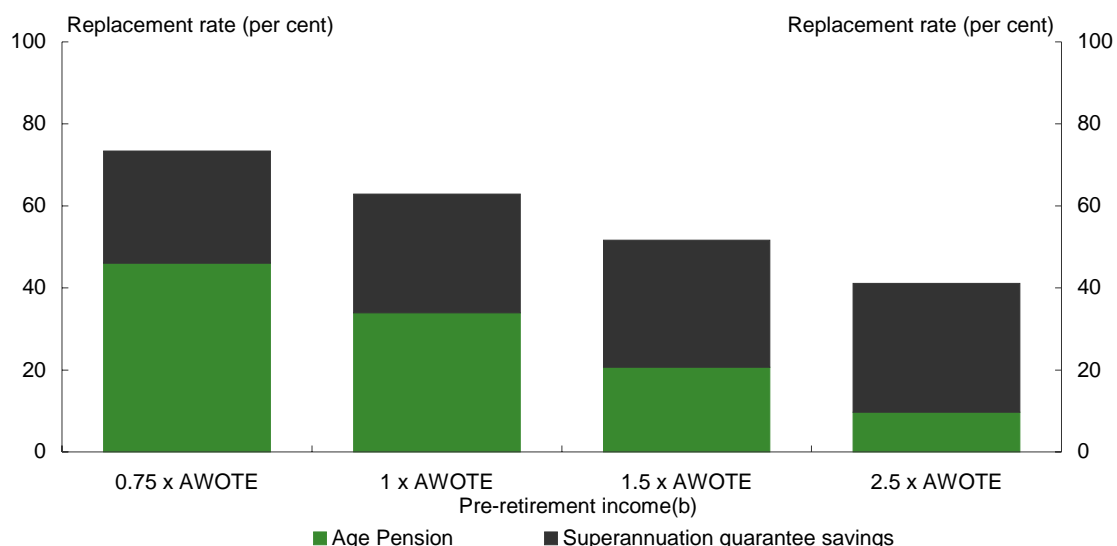
The retirement income system is still in transition and will not fully mature until the late 2030s when employees retire after a full working life (for modelling purposes, usually assumed to be 35 years) of compulsory superannuation contributions. As the system matures, retirement incomes based on the Age Pension and superannuation guarantee savings will gradually increase. During this transition, the Age Pension will decline as a proportion of retirement income.

The superannuation guarantee has not been designed to achieve a particular retirement income benchmark. It does not apply universally, the individual bears some or all of the investment risk, and the accumulated funds do not have to be used to fund a retirement pension. The length of time making contributions, the funding of insurance through superannuation and many other factors also affect retirement incomes.

Even so, there is increasing interest in retirement income adequacy, to which the superannuation guarantee obviously makes a contribution. Numerical assessments of adequacy usually provide estimates of the retirement income that might be generated for a hypothetical person who works for 35 years. This reflects the current average length of a working life for a primary earner, including periods outside the labour force (for example, studying or travelling). A replacement rate can be calculated to reflect how much of a person’s pre-retirement income they might expect to receive in retirement from the Age Pension and their compulsory superannuation savings.

Together with the Age Pension, the superannuation guarantee (when mature) may deliver replacement incomes for people on up to AWOTE of 60 per cent or more (Chart 4.1). Around half of this income will be provided by the Age Pension.

**Chart 4.1: Illustrative projected replacement rates under the Age Pension and superannuation guarantee<sup>(a)</sup>**



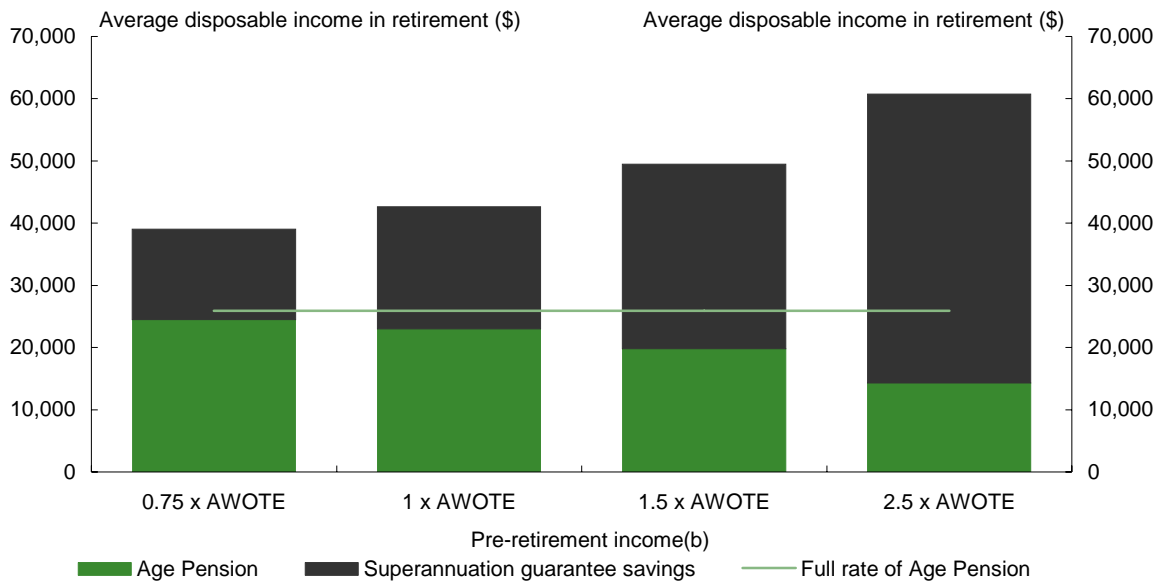
(a) A replacement rate compares an individual's spending power before and after retirement (that is, after tax is paid). For example, a replacement rate of 75 per cent would mean that an individual would be able to spend in a given time period \$75 in retirement for each \$100 spent before retirement. The illustrative replacement rates are projected for a hypothetical single person who works for 35 years and retires in 2035. It is assumed that at age 65 years they retire and use their superannuation guarantee benefit to purchase a lifetime annuity. The incomes used to calculate the illustrative replacement rates are deflated by the consumer price index to 2008-09 dollars. Actual outcomes will vary depending on factors such as workforce participation, labour income patterns, investment performance, inflation, longevity and whether an individual accesses their superannuation prior to Age Pension age.

(b) AWOTE is average weekly ordinary time earnings and is around \$1,150 per week (\$60,000 per year). Around half of workers earn less than three-quarters of AWOTE.

Source: Treasury projections.

Although their projected replacement rates are lower, people on higher pre-retirement incomes are projected to have a higher level of income in retirement from the Age Pension and the superannuation guarantee (Chart 4.2). For example, a person with a pre-retirement income of two and a half times AWOTE might be expected to have a disposable income in retirement of approximately \$60,000 per year. Someone with a pre-retirement income of AWOTE may have a disposable income in retirement of approximately \$43,000 per year.<sup>6</sup>

**Chart 4.2: Illustrative projected average disposable income in retirement under the Age Pension and superannuation guarantee<sup>(a)</sup>**



(a) Figures relate to retirement income in the year 2035, expressed in 2008-09 dollars. The illustrative real retirement incomes are projected for a hypothetical single person who works for 35 years. It is assumed that at age 65 years they retire and use their superannuation guarantee benefit to purchase a lifetime annuity. The illustrative average retirement incomes are deflated by the consumer price index. Projections are of disposable income, after tax and means testing are taken into account. Actual outcomes will vary depending on factors such as workforce participation, labour income patterns, investment performance, inflation, longevity and whether an individual accesses their superannuation prior to Age Pension age. In the chart, the full rate of pension is shown as \$26,000 compared with the existing rate of about \$15,000. This reflects the modelled annual 1.6 per cent increase in the value of the pension, reflecting wage related indexation.

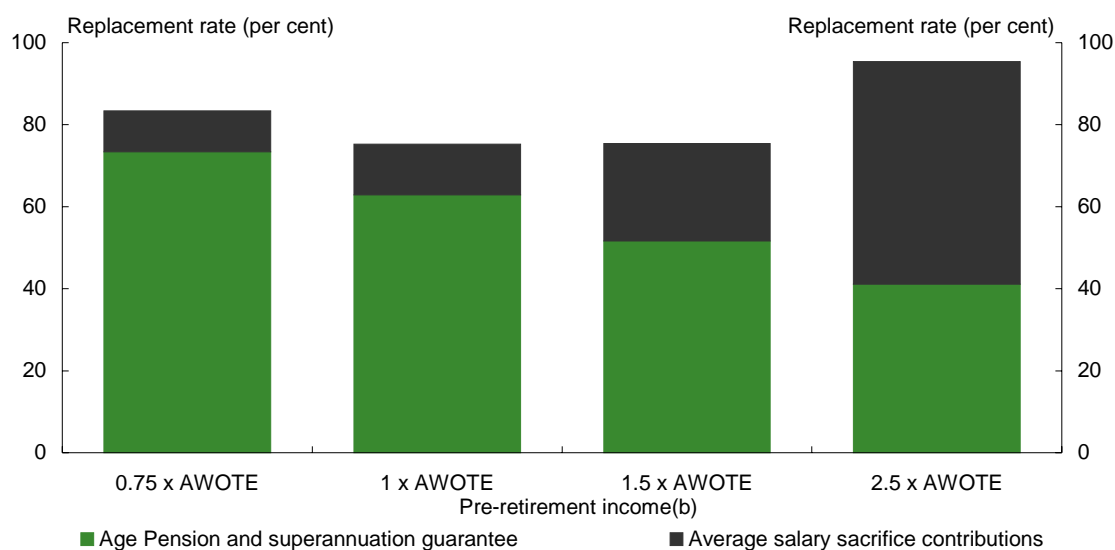
(b) AWOTE is average weekly ordinary time earnings and is around \$1,150 per week (\$60,000 per year). Around half of workers earn less than three-quarters of AWOTE.

Source: Treasury projections.

People on higher incomes also generally undertake higher levels of voluntary saving through the third pillar. Chart 4.3 shows illustrative replacement rates for a hypothetical individual who salary sacrifices into superannuation at the average rate for an employee of their age and level of remuneration. Including the third pillar generates higher illustrative replacement rates for higher income earners.

<sup>6</sup> Note that these projected disposable income estimates refer to a future year when AWOTE (even when discounted to today's dollars) will be considerably higher than the present level of \$60,000 because wages are projected to grow faster than prices.

**Chart 4.3: Illustrative projected replacement rates including the Age Pension, superannuation guarantee and average salary sacrificed amounts for employees<sup>(a)</sup>**



(a) A replacement rate compares an individual's spending power before and after retirement (that is, after tax is paid). For example, a replacement rate of 75 per cent would mean that an individual would be able to spend in a given time period \$75 in retirement for each \$100 spent before retirement. The illustrative replacement rates are projected for a hypothetical single person who works for 35 years and retires in 2035, making average salary sacrifice contributions for an employee of their age and level of salary and wage remuneration. It is assumed that at age 65 years they retire and use their superannuation guarantee benefit to purchase a lifetime annuity. The incomes used to calculate the illustrative replacement rates are deflated by the consumer price index to 2008-09 dollars. Projections are of disposable income, after tax and means testing are taken into account. Actual outcomes will vary depending on factors such as workforce participation, labour income patterns, investment performance, inflation, longevity and whether an individual accesses their superannuation prior to Age Pension age.

(b) AWOTE is average weekly ordinary time earnings and is around \$1,150 per week (\$60,000 per year). Around half of workers earn less than three-quarters of AWOTE.

Source: Treasury projections.

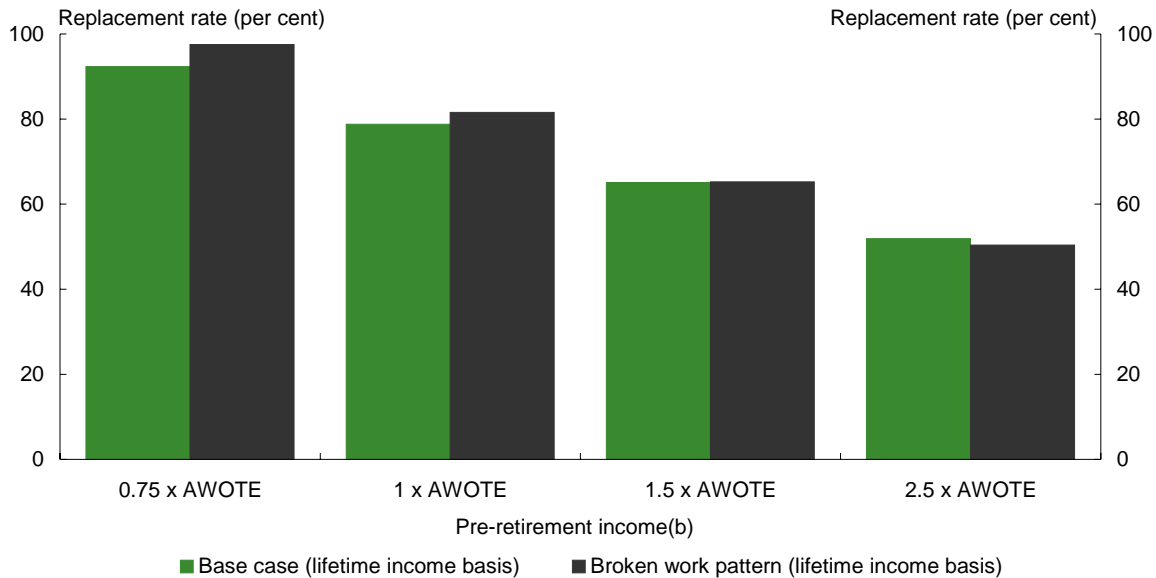
Excluding the self-employed from the superannuation guarantee significantly reduces the second pillar's coverage. However, the Age Pension covers the self-employed who have limited means to save for their retirement and around two-thirds of self-employed people make voluntary superannuation contributions (ABS 2008a). Wealth accumulated in their businesses also can be considered a form of voluntary savings. Capital gains tax exemptions exist on the sale of a small business where the business has been held for 15 years and the person is retiring or the person is aged 55 years or older and the proceeds from the sale of a small business are paid into a complying superannuation fund, an approved deposit fund or a retirement savings account in certain circumstances (up to a lifetime limit of \$500,000).

The outcomes from the superannuation guarantee and voluntary saving are strongly linked to workforce participation. Work patterns vary markedly due to gender, skills, individual work preferences and opportunities and migration. Groups with more varied work patterns, such as women, tend to experience lower retirement incomes. Some submissions argue these patterns result in deficient retirement incomes.

Retirement incomes for people with broken work patterns reflect their lower income and superannuation guarantee contributions over their working life. Using any one year of pre-retirement income is unlikely to provide a good indicator of the overall standard of living prior to retirement for a person with a variable work pattern. Their average income over their working life is a better indicator, as it balances years where they worked a lot and years where they worked less. Compared to their lifetime income, replacement rates based on the Age Pension and superannuation guarantee savings for people who move in and out

of work, may be similar to those for people who have a long work history at the same wage (Chart 4.4). The Age Pension will also tend to be more important for these people.

**Chart 4.4: Illustrative projected replacement rates (compared to average lifetime income) for a person with a broken work pattern under the Age Pension and superannuation guarantee<sup>(a)</sup>**



- (a) A replacement rate compares an individual's spending power before and after retirement (that is, after tax is paid). For example, a replacement rate of 75 per cent would mean that an individual would be able to spend in a given time period \$75 in retirement for each \$100 spent before retirement. These illustrative replacement rates are calculated by comparing average disposable income over an individual's entire lifetime (rather than in their final year of work) to their average disposable income during retirement. Average disposable income over an individual's lifetime provides a better measure of the pre-retirement standard of living for a person with variable work patterns. The base case illustrative replacement rates are projected for a person with a 35 year working life and retiring in 2035 are calculated on the same basis in this chart to provide a comparable benchmark. They are considerably larger than those shown in Chart 4.1. The illustrative replacement rates are for the Age Pension and superannuation guarantee. 'Broken work pattern' illustrative replacement rates are projected for a hypothetical person, aged 36 years in 2006. It is assumed they have no work history before age 36, part-time work between ages 36 years and 44 years, full-time work between ages 45 years and 49 years and part-time work between ages 60 years and 64 years. It is assumed that their partner's income means they do not receive income support in the years they do not work. Incomes used to calculate the illustrative replacement rates are deflated by the consumer price index to 2008-09 dollars. Actual outcomes will vary depending on factors such as workforce participation, labour income patterns, investment performance, inflation, longevity and whether an individual accesses their superannuation prior to Age Pension age.
- (b) AWOTE is average weekly ordinary time earnings and is around \$1,150 per week (\$60,000 per year). Around half of workers earn less than three-quarters of AWOTE.

Source: Treasury projections.

## 4.2 Acceptable

An assessment of equity in the retirement income system needs to take into account interactions with the broader tax-transfer system. Further, the assessment should consider the outcomes for individuals and families over their lifecycle, and between generations, including between future retirees and those taxpayers who will be funding the Age Pension and other publicly provided benefits. Basing the assessment on a subset of policy settings at a point in time may be misleading.

The overall treatment of an individual under the retirement income system depends on a broad range of factors. These include: taxation of superannuation contributions; taxation of earnings during accumulation and during retirement; government superannuation co-contributions; access to the Age Pension, including means testing; caps on superannuation guarantee contributions; and caps on concessional contributions and

non-concessional voluntary contributions. The overall treatment also depends on factors such as access to other concessions in retirement (such as health, transport and utilities concessions) and access to subsidised aged care and health services. Obviously the distributional implications of some components are difficult to assess.

The assessment provided here is of some elements of the present retirement income system. The Panel will undertake further work to improve its assessment of the distributional implications of the retirement income system for its final report.

## Tax concessions

Many submissions indicate concern about the fairness of superannuation taxation arrangements – in particular, a concern that higher income earners receive greater concessions than low income earners.

Superannuation guarantee contributions and earnings are taxed at a flat rate of 15 per cent. From one perspective, this means that the superannuation contributions of all people are treated equally. The concession addresses the bias otherwise present in income taxes favouring current over deferred consumption. From another point of view, it gives rise to a tax benefit, relative to the treatment of other earnings, that is larger for higher income earners with higher marginal tax rates (Table 4.2).

**Table 4.2: Personal income tax rates and superannuation contribution tax rates<sup>(a)</sup>**

Income range	Statutory personal tax rate (per cent)	Superannuation contribution tax rate (per cent)
\$6,000 and under	0	15
\$6,001 to \$34,000	15	15
\$34,001 to \$80,000	30	15
\$80,001 to \$180,000	40	15
\$180,001 and over	45	15

(a) Rates are for 2008-09.

However, identifying who benefits from these concessions is not a simple matter. For many lower income workers in receipt of income support or family payments, the superannuation guarantee and earnings tax rate is even more concessional because they face a higher effective marginal tax rate than the top marginal tax rate.<sup>7</sup>

In contrast, the 15 per cent contributions and earnings taxes provide only a small concession for lower income earners who do not receive income support and face marginal tax rates of 0, 15 per cent or 16.5 per cent (including the Medicare levy). A single person working full-time for the minimum wage receives only a very small concession from the superannuation tax system.

The 15 per cent contributions tax also provides only a small concession for discretionary superannuation contributions by lower income people, regardless of whether they receive income support. For the purposes of means testing of income support payments and family

7 For example, the 15 per cent superannuation guarantee contribution tax is more concessional for a middle income earner on a 31.5 per cent marginal tax rate (including the Medicare levy), who is also subject to the 20 per cent Family Tax Benefit Part A taper and the 4 per cent low income tax offset shade-out, than it is for a higher income earner facing a 46.5 per cent tax rate (including the Medicare levy). This is because superannuation guarantee contributions are not included as income for the purposes of determining eligibility for these benefits.



payments, current legislation will include in income salary-sacrificed (and tax deducted) superannuation contributions made at the discretion of an individual. This will mean that the size of concessions for these contributions is not dependent on whether an individual is eligible for income support and family payments. Accordingly, discretionary salary sacrificing (and tax deductibility) will provide little or no concession for lower income earners and larger concessions for higher income earners.

The co-contribution provides a higher rate of concession than salary sacrificing. There is no particular rationale for the co-contribution rate. Although it has a relatively high rate of concession, the co-contribution only applies to the first \$1,000 of voluntary contributions per year. This compares to an annual cap of up to \$50,000 on salary-sacrifice contributions (or \$100,000 under transitional arrangements).

In practice, the benefits of the superannuation concessions are accessed mainly by higher income earners, who have greater capacity to undertake voluntary saving. In 2005-06, around 5 per cent of taxpayers had remuneration over \$100,000, and they made around 24 per cent of concessional contributions to superannuation.

Table 4.3 outlines a projected superannuation contribution pattern for 2009-10.

**Table 4.3: Projected concessional superannuation contributions by remuneration (2009-10)<sup>(a)</sup>**

Annual remuneration <sup>(b)</sup>	Average annual contribution (\$)	Average contribution rate (per cent of remuneration)	Proportion of people making a contribution above \$25,000 (per cent)
\$20,000 and under	1,048	10.4	0.2
\$20,001-\$40,000	2,342	7.7	0.1
\$40,001-\$60,000	4,121	8.4	0.6
\$60,001-\$80,000	6,435	9.2	2.1
\$80,001-\$100,000	9,504	10.7	5.4
\$100,001-\$120,000	13,285	12.2	11.3
\$120,001-\$140,000	17,393	13.5	16.7
\$140,001-\$160,000	22,372	15.0	23.5
\$160,001-\$180,000	27,929	16.5	30.8
\$180,001-\$200,000	27,111	14.3	29.9
\$200,001-\$300,000	31,263	13.2	37.7
\$300,001-\$400,000	35,488	10.3	48.3
\$400,001-\$500,000	40,192	9.1	55.6
\$500,001 and over	46,347	4.4	64.1

(a) Treasury projections for 2009-10. Projections are based on 2005-06 data. Contributions in subsequent years were impacted by policy changes and are a less reliable basis for projecting contributions in 2009-10. Projections are adjusted for significant policy changes since 2005-06 (the introduction of the \$50,000 concessional contributions cap and \$100,000 transitional cap) and for changes in wages and population. The table includes both employees (and the superannuation guarantee and salary sacrifice contributions made by their employer) and the self-employed (who can make deductible contributions).

(b) Remuneration is taxable income plus salary sacrificed amounts plus fringe benefits. The average contribution rate can be below 9 per cent, as the definition of remuneration used in the table is different to the income base used to calculate the superannuation guarantee and the table includes people who are not covered by the superannuation guarantee.

Source: Treasury estimates.

The projections show that higher income earners make larger concessional contributions on average. The projected average rate of contribution also increases as remuneration approaches \$180,000 per year. The average rate of concessional contributions falls for people with remuneration above \$180,000 per year, in part due to the caps on concessional

superannuation contributions (currently \$50,000 per year for people aged under 50 years and \$100,000 per year for people aged over 50 years).

People on higher incomes are projected to continue to be much more likely to make large contributions. Of people making more than \$25,000 per year in concessional contributions, over 70 per cent have total remuneration above \$100,000 per year. Of people aged over 50 years contributing more than \$50,000, around 93 per cent have total remuneration above \$100,000 per year.

In contrast to the level of contributions made by higher income earners, only a quarter of low income people eligible for the superannuation co-contribution made voluntary superannuation contributions.

The equity of existing tax concessions for voluntary contributions is also influenced by the inability of some employees to access the tax concession because their employer does not offer salary sacrifice.

During retirement, earnings on superannuation savings receive preferential tax treatment compared to other savings, as they are tax-free. This is likely to provide a greater concession to individuals with greater superannuation savings.

### Other considerations

People cease to be covered by the superannuation guarantee when they reach age 70 years. This may result in people aged 70 years or older receiving lower total remuneration, for a given wage level, than people aged under 70 years.

The Age Pension means test comprises two components – an income test and an assets test. The two tests treat savings differently, and within the income test, the treatment of savings can differ depending on the form in which they are held. This means that individuals with similar levels of wealth can be paid different rates of pension. For example, while a person may have their pension reduced under the income test on the basis of assets they hold in their bank accounts or in a share portfolio, assets of the same value in non-income producing holiday houses, art collections and jewellery do not reduce pensions under the income test. While the assets test treats these assets uniformly, it may or may not apply depending on an individual's wealth and their mix of assets.

Equity between generations is also an important consideration for the design of the system. The ageing of the population and increasing life expectancies will affect how governments finance services and payments, including those made to retirees. These decisions can affect the level of services to, and the taxes paid by, different generations. The effects on future generations are hard to assess. However, increasing the cost of the retirement income system and imposing those costs on future generations would diminish intergenerational equity.

## 4.3 Robust

The framework of the system influences how it deals with shocks, such as the global financial crisis, and systemic changes in the demographic, social and economic environment, such as increases in life expectancy.

The spread of risk between the public and private sectors is a strength of the system. Too much reliance on the public sector can increase the cost of the system, affecting its sustainability and the ability of the government to keep its promises to individuals. Too much reliance on the private sector can expose people to excessive risk when saving for their retirement.

### Market risk

The global financial crisis has served to highlight the risk characteristics of the Australian retirement income system. With financial markets significantly repricing risk, and reassessing the global economic outlook, asset prices and the retirement savings of many individuals have fallen sharply. This highlights the inherent market risk associated with some forms of savings, something that is particularly significant for individuals relying primarily on the earnings and drawdown of their savings to fund their income in retirement. Of course, the Age Pension means test acts to ameliorate the impact for some retirees, as reduced private earnings result in an increased rate of pension payment.

While some retirees, and people on the cusp of retirement, may choose to undertake additional employment to increase their income, for others this is not a feasible option. People who are further from retirement have a longer time to recoup recent losses and build their retirement savings.

The system provides a range of investment options and products that enable people to choose the level of investment risk on their savings. Some commentators have speculated that large losses to superannuation savings may reduce confidence in the retirement income system and reduce voluntary superannuation saving. On the other hand, previous generations affected by financial crises have tended to become more risk averse and have relatively high rates of saving.

### Longevity risk

An emerging issue is how the current system caters for the risk that a person may outlive their savings. Continuing to allow a person to use their superannuation to finance an early retirement exacerbates this risk, due to the longer period over which a person's savings need to last.

Individuals find it unattractive to insure against this risk, with the main product available (lifetime annuities) being unpopular amongst retirees. The rate of return on these products is low, in part because these products are supported by safe but low return investments and in part because the people taking them up consider they will have a long life. This makes it difficult for providers to spread risk.

## 4.4 Simple and approachable

While the distribution of risk between the private and public sectors is a strength of the system, it imposes more responsibility and obligations on individuals in managing their retirement income.

An individual must make decisions on the appropriate way to invest their money, both before and after their retirement. For many, retirement will be the first time they are dealing

with both the tax and transfer systems. They must take into account how their decisions will affect their eligibility for the Age Pension. The current dual income and assets tests can result in people with the same wealth receiving different rates of pension, which can influence how a person chooses to hold their assets.

The removal of tax on most superannuation benefits in 2007 simplified the taxation arrangements. However, complexity remains. For example, there are circumstances where the different concessions provided to pre-tax contributions (deductions) and after-tax contributions (the superannuation co-contribution) require people to prescribe a split between these contributions to maximise their concession. Targeting concessions, such as by limiting who can claim a deduction on their superannuation contributions, also complicates the system.

The preferential taxation treatment of superannuation savings has seen a number of rules inserted into the superannuation system to limit the cost of the concessions. These rules include work tests for people aged 65 years or older, caps on contributions and the thresholds for the co-contribution. These rules assist in the sustainability of the concessions but they also produce complexity for both the industry and individuals. There are also rules relating to the splitting of contributions between couples, which can add further to complexity.

A key concern with a complex system is its regressivity – that is, complexity is most likely to have a greater effect on people who are least able, or have the fewest resources, to deal with it. A system that minimises the decisions required of individuals with lower financial capacity may be more acceptable than one that imposes equal cost on all individuals.

Given the very long timeframes associated with retirement income decisions, consistency in policy settings is important to individuals' planning and achievement of desired retirement incomes. Consistency of policy is also a desirable feature of a low cost and understandable system. Frequent policy changes can increase the administration costs of product providers and the costs of advice for individuals.

## 4.5 Sustainable

The high reliance on private self-funding and the means tests applying to pensions combine to make Australia's retirement income system more fiscally sustainable than most other systems, in the context of an ageing population. However, substantially increased fiscal costs are nonetheless projected over coming decades.

Significant challenges will result from Australia's changing demographics, driven by low fertility rates compared to the 1950s and 1960s and increased longevity, with only a partial offset from migration.

The increasing proportion of aged people in the total population presents a twin challenge. Firstly, it is becoming more difficult to ensure the retirement system is adequate, in part because many more people are living to a very old age. Secondly, it affects the fiscal sustainability of the retirement income system and other programs supporting the welfare of aged people.

The second intergenerational report (IGR2) (Australian Government 2007) projected that, on existing policy settings, Australian Government spending would increase by 4¾ per cent of GDP by 2046-47, due in part to demographic change.<sup>8</sup> The Productivity Commission (2005) has projected that state government expenditures could increase by 0.8 per cent of GDP by 2044-45.

A rough estimate of the increases in social spending that are driven by population ageing is outlined in Table 4.4, based on the projections in IGR2. This table isolates the demographic component of health and aged care. Around a quarter of the projected increase in health spending over the period to 2046-47 is estimated to be due to demographic change. The remaining three-quarters reflect the cost of improvements in, and wider availability of, advanced health technologies such as the development of new drugs and diagnostic techniques. The demographic component accounts for around three-quarters of the projected increase in total aged care spending. The Productivity Commission's projections for state government expenditures did not include information that the Panel could use to isolate the spending increases that are driven by demographic change (although it is likely to be the major factor).

**Table 4.4: Demographic related increases in Australian Government social spending<sup>(a)</sup>**

Spending area	Projected demographic related increase	
	2026-27 (per cent of GDP)	2046-47 (per cent of GDP)
Health	0.4	0.9
Aged care	0.3	0.9
Age Pension	1.0	1.9
<b>Total</b>	<b>1.7</b>	<b>3.7</b>

(a) Health projections reflect IGR2 projections of increased health spending, net of the impact of health technology (around three-quarters of the projected increase in IGR2). The projected increase in aged care spending is net of the impact of factors other than demographics (around a quarter of the projected increase in IGR2). Projected Age Pension increases are from IGR2.

Source: Calculated from IGR2.

In order to ensure long term fiscal sustainability, some combination of higher workforce participation, increased productivity growth, reduced expenditure or increased tax to GDP ratios, will be required to respond to these projected spending increases.

To put the projected social spending increases in perspective, in 2007-08, a 3.7 per cent of GDP increase in spending would have been equivalent to a third of the revenue raised from personal income tax, the entire revenue raised by the GST or the entire Australian Government health budget. If the Australian Government were to compensate the states and territories fully for their spending increases (as projected by the Productivity Commission) this would be equivalent to 7 per cent of personal income tax revenue or 20 per cent of GST revenue in 2007-08.

The outcomes of the retirement income system should be delivered at least cost to productivity, since pursuing economic growth is an important strategy in meeting the costs associated with demographic change. This has important implications for the design of superannuation, taxation and pension arrangements, all of which influence a person's decisions to work and save, affecting economic efficiency and growth.

<sup>8</sup> The IGR2 analysis is the latest publicly available analysis at the time of writing. The *Charter of Budget Honesty Act 1998* requires the Government to produce an IGR at least every five years. IGR2 was released in April 2007.

## 5. Age Pension and superannuation preservation ages

### 5.1 Recommendations

Responding to increasing longevity by increasing retirement ages would enhance the acceptability, adequacy and sustainability of the retirement income system. Higher retirement ages result in a smaller increase in the number of years spent in retirement, which has two broad effects:

- a moderation of total pension costs; and
- an increase in retirement incomes derived from lifetime savings.

The Age Pension age should be increased, initially to age 67 years. A review should be conducted by 2020 to examine the appropriateness of extending the increases. The Age Pension age provides a strong social signal about retirement expectations. Increasing it will signal changing retirement expectations linked to increasing life expectancies. At the same time, the Government should continue to promote workforce participation among older Australians.

The superannuation preservation age should also be increased, to align with the Age Pension age. An increase in the preservation age to 67 years could be phased in from 2024.

An increase in the superannuation preservation age should be coupled with mechanisms to allow early access to superannuation for those above age 60 years who are unable to continue to participate in the workforce due to disability.

### 5.2 Discussion

#### Age Pension age

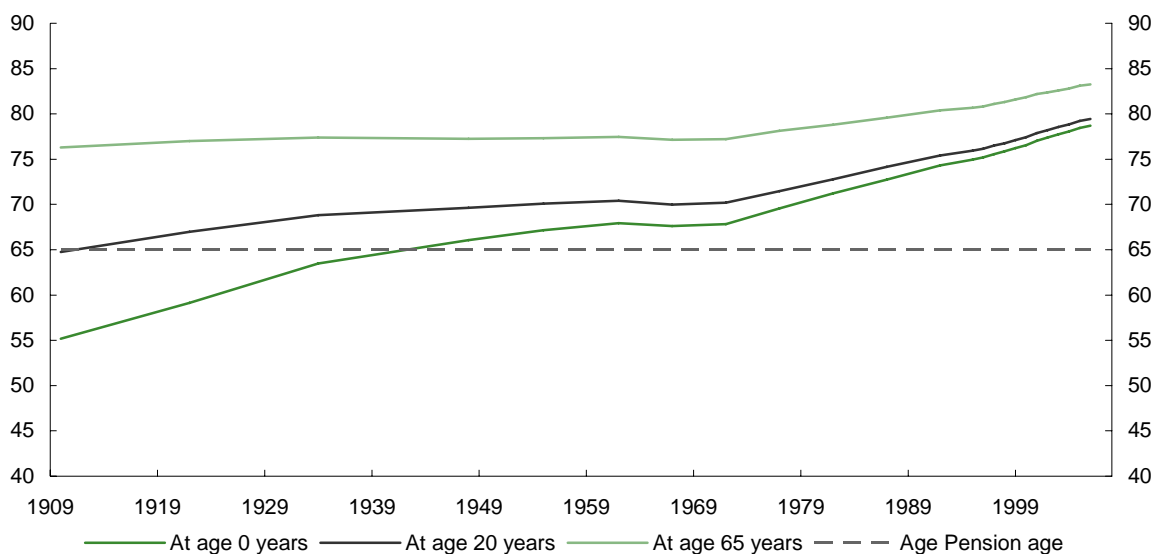
The long term costs of providing the Age Pension to an ever-growing proportion of the population are substantial. Demographic changes, including people living longer, are projected to result in an increasing number and proportion of people who will be eligible to receive the Age Pension in the future. IGR2 found that the ratio of working age to people aged 65 years and older will fall from 5 today to 2.4 by 2047.

There are significant implications for intergenerational equity of people receiving the Age Pension for an ever-growing proportion of their life. Because the Age Pension is paid from general revenue, those in retirement do not fund their own pension payments – their tax payments funded the Age Pensions of previous generations. An Age Pension that continues to provide more years of payment, and at higher rates, places a growing burden on working generations.

In contrast to life expectancy, the male Age Pension age has not changed since its introduction at the federal level in 1909, while the female Age Pension age has only been adjusted to align gradually with that of males.

At its introduction, the role performed by the Age Pension was very different from its role today. In 1909, the average male life expectancy at birth was 55 years. Age Pension age was set 10 years above average male life expectancy at birth and marginally above the average male life expectancy at age 20 years. Improvements in health outcomes for younger people have resulted in significant increases in life expectancy at birth and in the proportion of people who reach Age Pension age (Chart 5.1).

**Chart 5.1: Male life expectancy and the Age Pension age**



Source: ABS (2008b).

Until the 1970s, the amount of time that a person aged 65 years could expect to spend on the Age Pension remained fairly constant, at about 12 years. Since 1970, longevity has increased, by about 50 per cent, the length of time that a person aged 65 might expect to spend on the Age Pension.

### Increase the Age Pension age to reflect improved longevity

As noted in Section 3, the Panel recommends that the Age Pension age be increased to reflect the greater longevity of future pension recipients.

Many other OECD countries have recognised the need to change the Age Pension age. Iceland, Norway and the United States have already increased the pension age to 67 years and Denmark, Germany and the United Kingdom, are in the process of increasing the pension age to 67 years, or in the case of the United Kingdom, 68 years. Australia has the fourth highest life expectancy in the OECD and an increase to 67 years is reasonable, given an appropriate transition. Some submissions have also called for the Age Pension age to be increased, as have a number of articles.<sup>9</sup>

<sup>9</sup> CEDA (2007), Knox (2008).

People plan for retirement well before reaching retirement age, and the transition must be designed to minimise the impact on these plans. A gradual rate of change assists this and treats people of similar ages more equally.

It is proposed that the current five year difference between eligibility for the Age Pension and the Service Pension remain.

### **Health outcomes for older Australians**

Increasing life expectancy means that individuals will expect to have more years on the Age Pension. However, while individuals might expect to spend at least a portion of their additional life expectancy in good health, due to advances in health technology, a significant portion may be spent with a disability.

A number of studies find that health expectancies (the number of years spent in good health) have increased at a slower rate than life expectancy, indicating that the increase in the period that the average person could be expected to participate in the workforce would have grown at a slower rate than the growth in life expectancy. The Panel's recommended increase in the Age Pension age is consistent with these findings, as it only increases the Age Pension age by 2 years, compared to a 10 year increase in life expectancy since 1970.

### **Align the superannuation preservation age with the Age Pension age**

When existing changes are fully phased in, superannuation preservation restrictions will prevent access to superannuation savings until age 60 years. However, the gap between the superannuation preservation age and the Age Pension age means individuals can use their superannuation savings before they reach Age Pension age, such that, on average, approximately a third of superannuation savings are being drawn down before age 65 years.

Allowing these savings to finance early retirement detracts from the sustainability of the system in two ways – by increasing the length of retirement and reducing the amount of savings available to fund retirement. Only compulsory savings that are carried through to retirement take pressure off pension expenditures, through the pension means test. Arrangements that encourage shorter working lives also reduce participation rates and place a greater tax burden on those who work. They are also inconsistent with the need to consider ways to reduce the risk of people outliving their savings due to increasing life expectancies.

The preservation age is currently legislated to increase to 60 years by 2024. The preservation age should continue to be adjusted until the preservation age is aligned with the Age Pension age. Thereafter, the preservation age should remain aligned with the Age Pension age.

### **Early access arrangements**

Under existing rules a person can access their superannuation prior to the preservation age on hardship grounds, permanent disablement or by purchasing an income stream for life. These provisions intend to meet the needs of people who are required to retire early. The recommendation in Section 7 will assist the ability of people to purchase a lifetime income stream product.



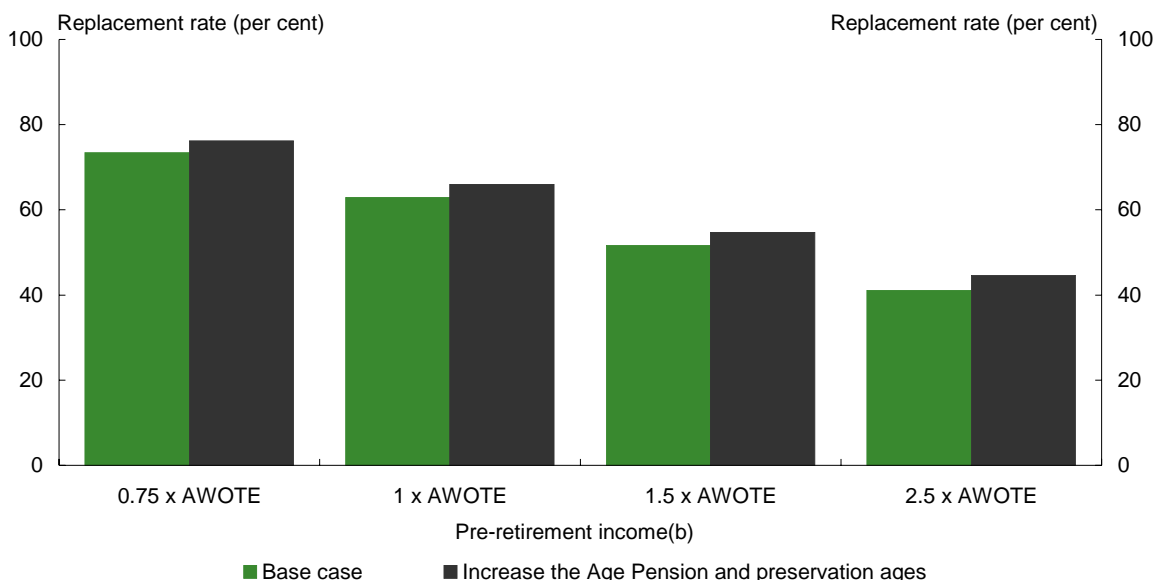
### Other alignment issues

The Panel’s final report will explore further some other issues associated with aligning the preservation age with Age Pension age. These include some occupations which have mandatory retirement ages below age 67 years and Service Pensioners who are proposed to continue to be able to access the Service Pension five years prior to Age Pension age.

### Cumulative impact on retirement incomes

Increasing the Age Pension and preservation ages would increase projected retirement incomes, as individuals would spend longer accumulating retirement savings and spread those savings over fewer years in retirement. As shown in Chart 5.2, the proposed Age Pension and superannuation preservation ages are projected to increase replacement rates for a person on AWOTE from 63 per cent to 66 per cent.

**Chart 5.2: Illustrative projected replacement rates showing the impact of changes to the Age Pension and preservation ages<sup>(a)</sup>**



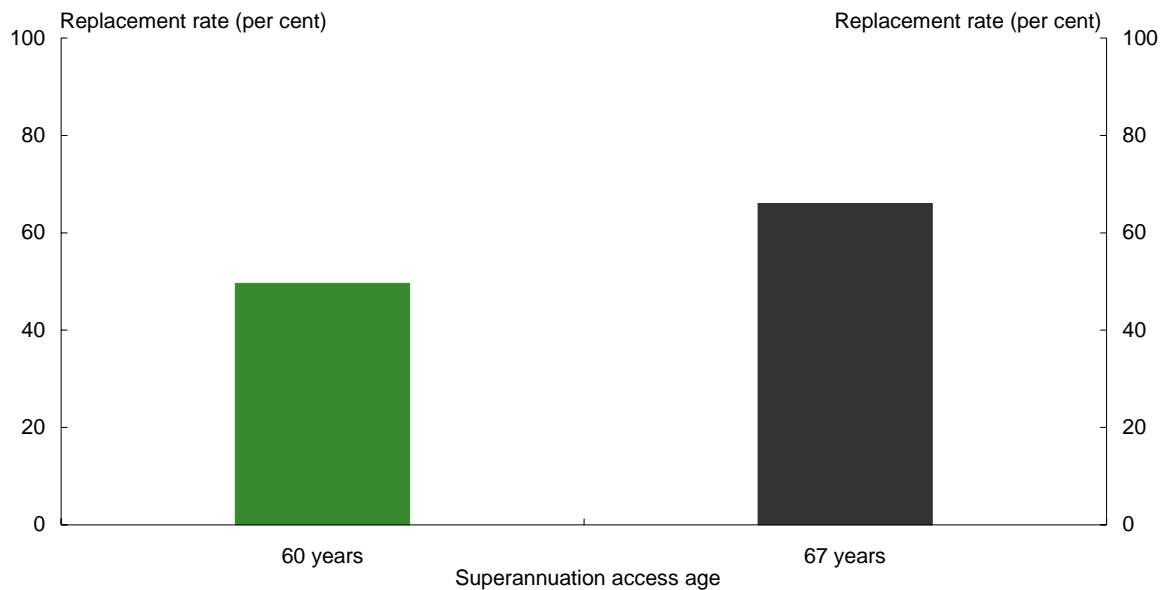
(a) A replacement rate compares an individual's spending power before and after retirement (that is, after tax is paid). For example, a replacement rate of 75 per cent would mean that an individual would be able to spend in a given time period \$75 in retirement for each \$100 spent before retirement. The base case illustrative replacement rates are projections for a hypothetical single person who works for 35 years and retires in 2035. The illustrative replacement rates are for the Age Pension and superannuation guarantee. At age 65 years they retire and use their superannuation guarantee contributions to purchase a lifetime annuity. The illustrative replacement rates including the Age Pension and preservation age changes are for a hypothetical single person who works for 37 years and retires in 2037. At age 67 years they retire and purchase a lifetime annuity. The replacement rates are deflated by the consumer price index to 2008-09 dollars. Actual outcomes will vary depending on factors such as workforce participation, labour income patterns, investment performance, inflation, longevity and whether an individual accesses their superannuation prior to Age Pension age.

(b) AWOTE is average weekly ordinary time earnings and is around \$1,150 per week (\$60,000 per year). Around half of workers earn less than three-quarters of AWOTE.

Source: Treasury projections.

The hypothetical individual in the base case in Chart 5.2 is assumed to access their superannuation only after they reach Age Pension age. In practice, many people access their superannuation before Age Pension age. Chart 5.3 compares the illustrative replacement rates of two individuals, each with an identical 37 year working life earning AWOTE. One starts to access their superannuation when aged 60 years, while the other accesses it when aged 67 years. The chart shows that spreading a given amount of superannuation savings over fewer years can significantly increase replacement rates.

**Chart 5.3: Illustrative projected replacement rates for a person earning AWOTE who accesses superannuation at age 67 years, rather than at age 60 years<sup>(a)(b)</sup>**



(a) A replacement rate compares an individual's spending power before and after retirement (that is, after tax is paid). For example, a replacement rate of 75 per cent would mean that an individual would be able to spend in a given time period \$75 in retirement for each \$100 spent before retirement. Both illustrative replacement rates are projections for a hypothetical single person who works for 37 years (i.e. including the Age Pension age changes) and retires in 2037. The illustrative replacement rates are for the Age Pension and superannuation guarantee. In the 'Access super at age 60 years' scenario, they access their superannuation from age 60 years, drawing down in a manner that replicates a lifetime annuity stream. In the 'Access super at age 67 years' scenario, they access their superannuation from age 67 years, purchasing a lifetime annuity. The illustrative replacement rates are deflated by the consumer price index to 2008-09 dollars. Actual outcomes will vary depending on factors such as workforce participation, labour income patterns, investment performance, inflation, longevity and whether an individual accesses their superannuation prior to Age Pension age.

(b) AWOTE is average weekly ordinary time earnings and is around \$1,150 per week (\$60,000 per year). Around half of workers earn less than three-quarters of AWOTE.

Source: Treasury projections.

## Other age limits

There are a number of other age-based restrictions in the superannuation system which will be taken into account as part of the broader review of the tax-transfer system, reflecting their links with the taxation of labour and capital income.

There are a range of age limits that affect contributions. The superannuation guarantee is paid until a person reaches age 70 years. After this age, employers are not obliged to make superannuation guarantee contributions, but individuals can make discretionary contributions until they are aged 75 years, subject to a work test.

The capital gains tax retirement exemption contains an age restriction which is aligned with the preservation age. The concession exempts small business owners from paying capital gains tax when they sell 'active assets' that have been used in their business and immediately roll the proceeds into a superannuation fund. If the taxpayer is aged over 55 years, they have the option of taking the proceeds as cash, instead of rolling them into superannuation.

## 6. Age Pension means testing

### 6.1 Recommendations

Some features of the current means tests result in an unequal treatment of pensioners with similar levels of private means. These features, in combination with the tax system, can influence people's choices about the form in which they hold assets. Inconsistencies in scope between the income and assets tests also reduce system coherence.

A single means test which removes the assets test and extends the income test by extending deeming to a greater range of assets would have the potential to improve the fairness and coherence of the retirement income system. Under this approach, key design parameters could include:

- a consistent approach across a broad range of assets;
- an allowance for a reasonable level of personal assets, such as household furnishings, jewellery and motor vehicles; and
- concessional treatment of income from employment, to improve incentives to undertake paid work.

Owner-occupied housing provides important economic and social benefits to retirees and should continue to be generally exempt from pension means testing. However, to increase the fairness of the pension system, consideration should be given to setting a limit (at a high level) on the value of the exemption provided in respect of owner-occupied housing.

Recommendations for a single means test and its interaction with the broader tax-transfer system will be included in the Panel's final report. The means testing of pensions is closely associated with broader considerations relating to the taxation of income and assets and the overall progressivity of the tax-transfer system. The feasibility of a single means test will depend on consideration of administrative and delivery issues, as well as the distributional impacts of such an approach.

### 6.2 Discussion

#### Current arrangements

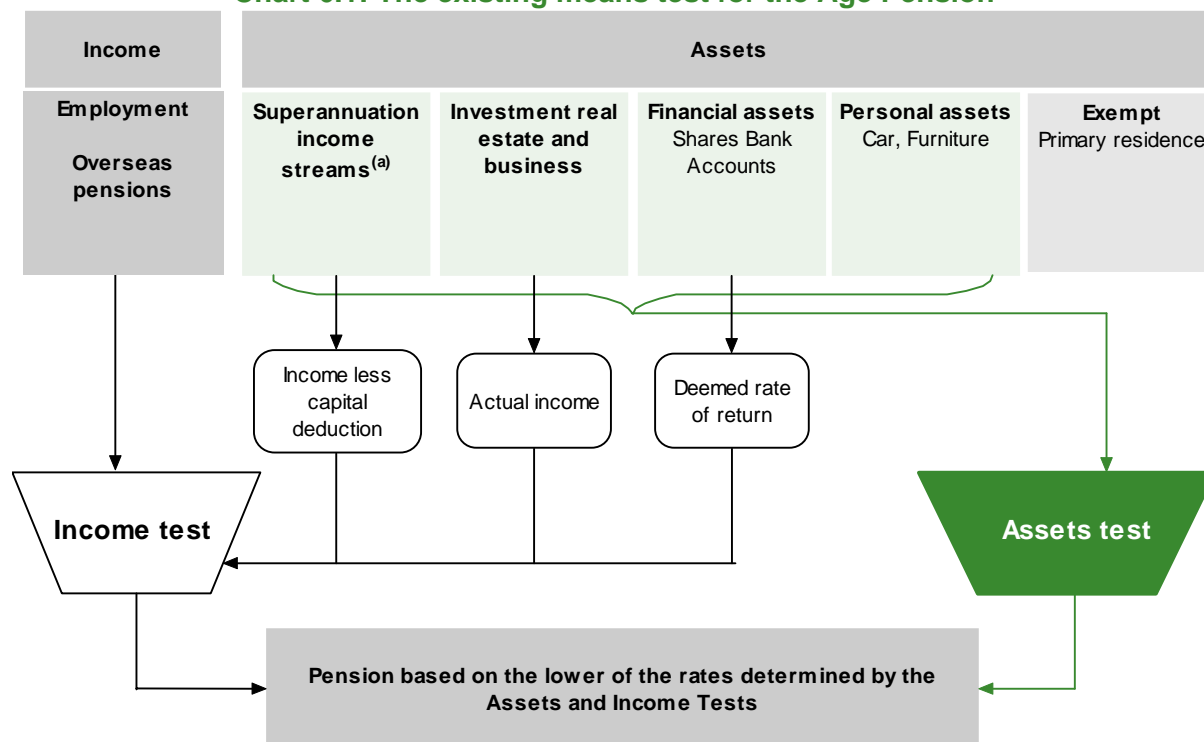
The Age Pension means test determines the rate of payment that Age pensioners receive. The pension means test has two parts: an income test and an assets test (Chart 6.1). A person's pension is calculated by applying the test that results in the least pension.

- The income test applies a 40 per cent taper to income above a threshold (\$3,588 per annum for a single person). It applies directly to earned income, but uses a

variety of methods to assess income from savings. A part pension is payable to a single person with private income up to around \$41,000.

- The assets test includes most assets, with the principal home exempt (and a higher assets test free-area for non-home owners). The assets test reduces Age Pension receipts by \$1.50 per fortnight (or \$39 per year) for every \$1,000 of assets over the free-area. A pension is payable to a single homeowner with assets in addition to the principal home up to \$555,750.

**Chart 6.1: The existing means test for the Age Pension**



(a) Superannuation accumulations (not being drawn down through an income stream) are treated as financial assets.

Around 41 per cent of pensioners currently have their rate reduced by the means test – 32 per cent by the income test and 9 per cent by the assets test – with the role of the assets test increasing over time. However, for most pensioners, the reduction in the rate of the pension as a result of means testing is relatively small – around 73 per cent of pensioners receive over 90 per cent of the maximum pension rate and only 3 per cent receive less than 25 per cent of the maximum rate.

### Assessing the effectiveness of the existing means test

The two tests treat savings differently and, within the income test, the treatment of savings can differ depending on the form in which it is held. This means that individuals with similar levels of wealth can be paid different rates of Age Pension. For example, while a person may have their pension reduced under the income test because they hold income producing assets in their bank accounts or in a share portfolio, a person holding assets of the same value in non-income producing holiday houses, art collections and jewellery would not have their pensions reduced under the income test.

The assets test can create relatively high effective marginal tax rates on income from savings. A pension reduction of \$1.50 per fortnight per \$1,000 worth of assets over the asset test

threshold equates to an effective marginal taper rate on income of 78 per cent, assuming a 5 per cent annual income return. Effective marginal tax rates will vary depending on asset holdings and the assumed rate of return.

Further, some treatments of financial assets within the income test (for example, the calculation of assessable income from purchased superannuation income streams) do not reflect the actual flow of income that pensioners receive from these investments.

As a consequence, means testing is not as equitable as it could be. It may also create disincentives for the productive use of assets, with potentially adverse effects on economic efficiency and the long term sustainability of the Age Pension system.

The means tests also interact with the taxation system in complex ways, producing in combination a wide range of effective tax rates, and this also is less fair and coherent than it could be.

### An alternative approach

An alternative single means test should:

- ensure the full range of an individual's retirement savings is effectively and fairly assessed in the pension means test;
- be more neutral in the treatment of different forms of retirement savings;
- ensure there are appropriate incentives for people to use their retirement savings effectively;
- provide appropriate incentives for older Australians who wish to continue to undertake paid work; and
- contribute to the fairness of the overall tax-transfer system.

This could be done by effectively extending the current 'deeming' approach to superannuation and non-financial assets, such as personal effects, holiday homes, land and collections.

However, several important issues would need resolution:

- appropriate deeming rate(s), given the level and diversity of assets;
- whether assets should be deemed or whether account should be taken of actual income streams;
- the structure of the free-areas, including the treatment of personal assets;
- the appropriate treatment of non-commutable income streams;
- the extent to which employment-related income is treated concessionally to promote workforce participation;

- the taper rates that best achieve balance between incentives to work and save, effective targeting and fiscal considerations; and
- the appropriate assessment of businesses and trust structures.

The ultimate design of such a means test would also depend on its interaction with the personal income tax system. The Panel will be seeking to better integrate the operation of the means test with the personal income tax system and, where possible, reduce the likelihood of an individual having to interact with both systems.

## Housing

Owner-occupied housing plays an important role in Australia's retirement income system.

- It is part of lifecycle income smoothing. In retirement, home owners save on rental costs, freeing up their income for other consumption.
- It is frequently used by retirees as a form of longevity insurance. The capital value of a home can be used as a 'backstop', including as a source of funding for residential care, if they outlive their other savings.
- Home ownership provides a range of benefits above the pure rental value of the housing, including security of tenure and living in the same neighbourhood for a long period of time. These are important for the social integration and participation of retirees.

The great majority of retirees are home owners and the adequacy of pensions has been determined on this basis (with renters receiving separate assistance). Savings invested in owner-occupied housing generally do not generate cash-flow incomes. For these reasons, the Panel supports the continued exemption of owner-occupied housing from the pension means test. However, the provision of an uncapped exemption provides an opportunity for very high levels of wealth to be sheltered from means tests. To increase the fairness of the pension system, the Panel proposes in the development of the new means test to give consideration to setting a limit on the value of the exemption of owner-occupied housing.

## 7. Insuring against longevity risk

### 7.1 Recommendation

Longevity insurance should form part of a suite of options available to people to insure against the risk they will outlive their assets in retirement.

In its final report, the Panel will give further consideration to the type of products and the appropriate role of the government in assisting with the development of these products.

### 7.2 Discussion

Australians have one of the longest life expectancies in the world. Advances in health technologies are likely to result in each generation living longer than the preceding generation. On current trends, men aged 60 years in 2047 are projected to live an average of 5.1 years longer than those aged 60 years in 2007 and women an average of 4.7 years longer (Australian Government 2007).

Life expectancies refer only to averages. The numbers of people living longer than average life expectancy is growing very rapidly and will continue to do so.

Thus there are two types of longevity risk. First, for the whole population, there is the risk that average life expectancies will increase. Second, for each individual, there is the risk that their life will extend into late age beyond average expectancy.

The length of a person's life will have a significant influence on how long they can potentially sustain income above the Age Pension through use of their superannuation and other savings. The Age Pension already incorporates a full longevity risk insurance feature – it is paid for as long as an eligible pensioner lives (and no longer). However, few people have superannuation products which meet the same longevity risk needs.

#### Longevity insurance

Some submissions suggest individuals be required to use their superannuation to purchase a retirement income stream and/or that restrictions be imposed on access to lump sums. There is concern that flexibility in the use of superannuation may detract from the objective of promoting higher retirement incomes.

However, this flexibility enables people to make decisions in their best interests and is likely to result in outcomes largely consistent with the broader objective of promoting retirement saving.

The uncertainty about when a person will die makes managing their assets to last over their lifetime very difficult. The market in Australia for products that provide either a lifetime, or deferred income stream is not as developed as in some other countries.

## Issues

In developing proposals relating to longevity insurance, it will be necessary to consider whether (or to what extent) the insurance:

- is mandatory or voluntary;
- provides guaranteed or non-guaranteed income; and
- is provided by the public or private sector.

### Mandatory or voluntary

Under a mandatory scheme, people would invest a proportion of their superannuation (whether during the contribution process or at a later point from accumulated balances) into a pool, from which an income would be paid from a nominated age.

The introduction of a mandatory scheme for accumulated balances may be difficult to implement in the short to medium term for a number of reasons. Superannuation balances are unlikely to support significant income streams for many years, as the compulsory system is still maturing. Even when the system is mature, many people will not have a full working life of compulsory saving due to periods outside the workforce and others, such as migrants, entering the system at a later age.

In a mandatory scheme, people who die before or shortly after the age at which the annuity commences support the income of those who live longer. Consequently, there are potential equity issues, especially for groups in the community who tend to have lower life expectancies, such as low income earners and Indigenous Australians.

A voluntary system would mean a person can insure as much of the risk as they wish. However, the pool would not be as large as under a mandatory system. This would place more risk on the provider, as the people choosing to insure are more likely to be those who consider they have a good chance of living beyond average life expectancies. The provider would pass on this risk by offering a lower income than might be payable under a mandatory scheme. This is particularly the case where the income is guaranteed.

### Guaranteed or non-guaranteed products

The provision of a guaranteed income, while providing greater certainty for retirees, would present several challenges. For example, providers would need to satisfy the capital requirements set by the Australian Prudential Regulation Authority (in respect of reserve and matching requirements), which could increase the cost of the product. Providers would also need to price expected mortality improvements into the products, which would be challenging to predict accurately. Given these challenges, it is likely that the products in the private sector could be offered only by life insurance companies.

With a non-guaranteed product, a person does not purchase a right to an income but a right to a distribution from a pool of assets. This moves the investment and mortality risk from the provider to the individual. These assets have similar risk characteristics to those applying in the accumulation phase, with the exception that investment returns are supported by deaths of the members within the pool.



### **Private versus public provision**

Private entities, such as life insurance companies, can already provide products that insure an income over a person's life. Depending on the product, other entities may also be able to enter this market.

The government is already the main provider of longevity insurance through the Age Pension. This may provide the infrastructure to enable a person to purchase an additional guaranteed income. The government may also be able to offset the risks inherent in offering an income guarantee more effectively than the private sector, especially if the government has to insure private sector guarantees.

# Appendix A: Terms of reference

## Australia's future tax system

### Objectives and scope

1. The tax system serves an important role in funding the quality public services that benefit individual members of the community as well as the economy more broadly. Through its design it can have an important impact on the growth rate and allocation of resources in the economy.
2. Raising revenue should be done so as to do least harm to economic efficiency, provide equity (horizontal, vertical and intergenerational), and minimise complexity for taxpayers and the community.
3. The comprehensive review of Australia's tax system will examine and make recommendations to create a tax structure that will position Australia to deal with the demographic, social, economic and environmental challenges of the 21st century and enhance Australia's economic and social outcomes. The review will consider:
  - 3.1. the appropriate balance between taxation of the returns from work, investment and savings, consumption (excluding the GST) and the role to be played by environmental taxes;
  - 3.2. improvements to the tax and transfer payment system for individuals and working families, including those for retirees;
  - 3.3. enhancing the taxation of savings, assets and investments, including the role and structure of company taxation;
  - 3.4. enhancing the taxation arrangements on consumption (including excise taxes), property (including housing), and other forms of taxation collected primarily by the States;
  - 3.5. simplifying the tax system, including consideration of appropriate administrative arrangements across the Australian Federation; and
  - 3.6. the interrelationships between these systems as well as the proposed emissions trading system.
4. The review should make coherent recommendations to enhance overall economic, social and environmental wellbeing, with a particular focus on ensuring there are appropriate incentives for:
  - 4.1. workforce participation and skill formation;

- 4.2. individuals to save and provide for their future, including access to affordable housing;
  - 4.3. investment and the promotion of efficient resource allocation to enhance productivity and international competitiveness; and
  - 4.4. reducing tax system complexity and compliance costs.
5. The review will reflect the Government's policy not to increase the rate or broaden the base of the GST; preserve tax-free superannuation payments for the over 60s; and the announced aspirational personal income tax goals.
  6. The review's recommendations should not presume a smaller general government sector and should be consistent with the Government's tax to GDP commitments.
  7. The review should take into account the relationships of the tax system with the transfer payments system and other social support payments, rules and concessions, with a view to improving incentives to work, reducing complexity and maintaining cohesion.
  8. The review should take into account recent international trends to lower headline rates of tax and apply them across a broader base, as well as domestic and global economic and social developments and their impact on the Australian economy.
  9. The review will also incorporate consideration of all relevant tax expenditures.

## Composition and consultation

10. The Review Panel will be chaired by the Secretary to the Treasury, Dr Ken Henry AC and will also comprise Mr Greg Smith (Australian Catholic University); Dr Jeff Harmer (Secretary of the Department of Families, Housing, Community Services and Indigenous Affairs); Ms Heather Ridout (Australian Industry Group); and Professor John Piggott (University of New South Wales).
11. The Review Panel will be supported by a working group from within the Treasury, with representation from the Department of Families, Housing, Community Services and Indigenous Affairs, drawing on other Australian government and state agencies as appropriate.
12. The Chair may task members of the Review Panel to oversee programs of work related to their field of expertise.
13. The Review Panel will consult the public to allow for community and business input.
14. The review will also, where necessary, draw on external expertise and shall have the cooperation of state governments and their Treasuries as well as relevant COAG working groups.
15. The Minister for Families, Housing, Community Services and Indigenous Affairs will provide input on issues related to transfer payments, family assistance and retirement incomes.

## Structure and timing

16. The review process will be conducted in several stages. These will follow the release of an initial discussion paper by Treasury on the architecture of the tax system and an examination of the existing tax rates and bases (excluding the GST). The paper will be released by the end of July 2008.

17. The Review Panel will provide a final report to the Treasurer by the end of 2009. The Government will respond in a timely way to the tax review's recommendations as they are released.



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Dr Ken Henry AC  
Chair  
Australia's Future Tax System Review  
The Treasury  
Langton Crescent  
PARKES ACT 2600

4 NOV 2008

Dear Dr Henry 

I am writing to request the review into Australia's future tax system bring forward its consideration of the retirement income system and report to the Government by the end of March 2009.

The Government wishes to examine the findings of Dr Harmer's review of pensions in conjunction with your Panel's review of the other aspects of the retirement income system. This will allow the Government to consider a broader and complementary response to the issues facing the retirement income system than those issues being considered by Dr Harmer.

In your report, I request that the Panel include recommendations on the adequacy of the retirement income system and the appropriateness of the current taxation arrangements.

Yours sincerely

WAYNE SWAN

## Appendix B: Consultation questions

### The retirement income system

- Q1.1 In considering the future of Australia's retirement income system, which objectives are relevant in setting retirement income policy? Does the current system of the Age Pension and compulsory and voluntary savings meet these objectives? If not, how should the system be changed to meet these objectives?

### A broad and adequate retirement income system

- Q2.1 As the superannuation guarantee system matures, it will become a greater part of an employee's retirement income. What are the implications for individuals partially or fully excluded from the mature superannuation guarantee system (the self-employed, individuals with broken work patterns such as carers, women and migrants), and how can the retirement income system best accommodate these groups?
- Q2.2 Noting that the adequacy of the Age Pension is being considered by the Pension Review, what is an appropriate concept of adequacy for the retirement income system? Should it be to ensure there is a minimum level of income in retirement, to replace a proportion of income earned prior to retirement, or some other alternative?
- Q2.3 What should the role of the government be in assisting individuals to meet their retirement income expectations in relation to the support provided by the Age Pension, the level of compulsory savings and incentives to make additional savings? Should the role of government change as an individual's income increases over their working life?

### An acceptable retirement income system

- Q3.1 Do the settings of the retirement income system, such as the level of superannuation guarantee and access to concessions, adequately consider the needs and preferences of individuals both before and after retirement?
- Q3.2 Is the current level of superannuation income tax concessions appropriate and sustainable into the future? Are the current concessions properly targeted, and if not, how should they be reformed?

## **A robust retirement income system**

- Q4.1 At what age should an individual be able to access their superannuation and at what age should they become eligible for the Age Pension?
- Q4.2 What is the role of individuals in dealing with investment and longevity risk in accumulating and drawing down their retirement income? Do financial markets provide the means to deal with these risks? If not, is there a role for government to address these shortcomings?

## **A simple and approachable retirement income system**

- Q5.1 In what ways does the retirement income system impose undue complexity and cost on retirees and workers? How could this complexity be reduced?

## **A sustainable retirement income system**

- Q6.1 The Age Pension serves two roles, as a safety-net for individuals who are unable to sufficiently save for their retirement and as an income supplement for many individuals who do save. What should be the role for the Age Pension and means testing in a future retirement income system and what impact does this have on its sustainability into the future?
- Q6.2 In what ways does retirement income policy affect workforce participation decisions and what, if any, changes might reduce disincentives to work? Does the sustainability and cost of the retirement income system affect the workforce decisions of younger generations of workers?
- Q6.3 What impact could financial intermediation have on the effectiveness of retirement income policy?

## Appendix C: List of submissions

The Panel received around 160 submissions on the retirement income system, including approximately 100 from individuals. These submissions contributed to the development of this report.

Submissions are treated as public documents unless authors have specifically requested confidentiality. Authors of public submissions to the review are listed below. Authors who requested confidentiality, or whose submissions contain personal information, are not listed.

Australian Association of Former International Civil Servants	Bryce, Les	Falzon, Brendon
AMP	BT Financial Group	Feitsma, Hans H
Anglicare Australia	Buch, Jonathan	Financial Planning Association of Australia Limited
Anstey, Harry	But, Michelle	Fisher, George
Arnold Milton Pty Ltd	Butterworth, Perce	Fitzgerald, Julie
Association of Former Members of the South Australian Parliament	Carers Australia	Fletcher, Bill
Association of Independent Retirees	Cesta, Dino	Ford, Margaret and Norman
Association of NZ Retirees in Australia	Challenger Financial Services Ltd	Gunn, Ray
Association of Superannuation Funds of Australia	Chapman, Jeff	Hawkins, Graeme
Australian Bankers' Association Inc	CHOICE	Hayes, Tom
Australian Council of Public Sector Retiree Organisations Inc	Clayton Utz	Heathers, John
Australian Council of Social Service	Combined Pensioners and Superannuants Association of NSW (CPSA)	Hodgkinson, Norman
Australian Council of Trade Unions	Consumer Action Law Centre	Hoedt, Sherlock de
Australian Human Rights Commission	Corporate Super Association	Hollingsworth, David B
Australian Institute of Superannuation Trustees	Cossar, Geoff	Homan, Stewart
AXA Asia Pacific Holdings Limited	Council of the Ageing (Over 50s)	Homesafe Solutions
Axiom Wealth Pty Ltd	CPA Australia	Hughes, Stephen
Bernstone, Racheal	Craig, Thora	Industry Funds Forum
Bhati, UN	Crisp, Phillip	Industry Super Network
Birdseye, Carol	Cross, Ronald William	ING Australia
Breen, James	Daly, Denis	Ingles, David
Brooks, Geoff	Defence Force Welfare Association	Institute of Actuaries of Australia
Brotherhood of St Lawrence	Ditchburn, Paul	Institute of Chartered Accountants in Australia
Broughton, John	Dixon Advisory	Investment and Financial Services Association
Brown, Lindsay	Drew, Les RH	Jamieson, Lyn
Brown, Stephen Graham	Dwyer, Terence	Jensen, Dennis
	Erwin, Russ	Jensen, Gerald
	Evans, Neil	Kenna, John
	Fairhall, Lloyd B	



## Retirement Income Report

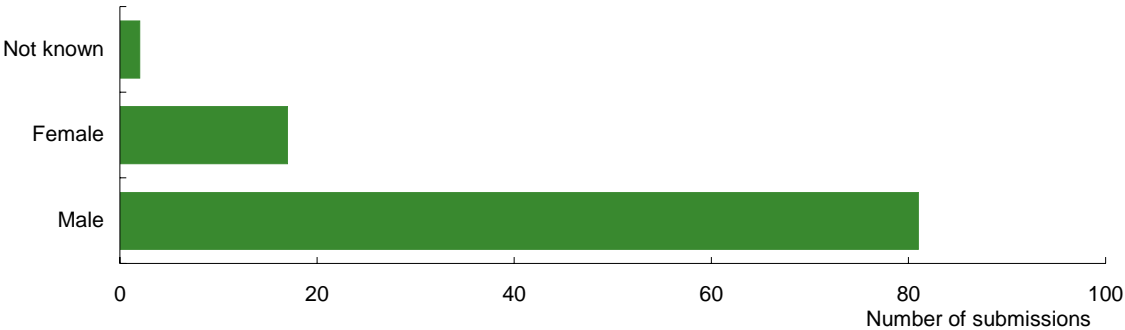
KPMG Superannuation Services Pty Ltd	Pursehouse, Grahame	Webb, Jeff
Leslie, Roger C	Rantzen, John	Whitlam, Christine
Lifschitz, Stanford	Redmond, Tom	Wickham, Darren
Macdonald, Randal	Revenue Review Foundation	Woods, Fay
Macquarie Investment Services	Rice Warner Actuaries	Women's Electoral Lobby Australia
Maloney, Stephen	Roberts, David	Women in Science and Economic Research, Curtin Business School
Martin, Basil	Romano, Edward	Wright, Marie Cornelia
McIntosh, Stephen	Rowland, Jennifer J	YWCA Australia
McIntyre, Peter	Rue, John de la	
Mercer	Rumney, Clive	
Meyer, Narelle	Scarf, Gary E	
Mills, Alan	Self Managed Superannuation Fund Professionals' Association of Australia	
Milton, Arnold	Senior Australians Equity Release Association of Lenders	
Montfort International	Seve, Joanne	
Moore, Christopher	Severn, Zona	
Moore, Roger	Shrapnel, John and Joan	
More, Tom	Skinner, Betty	
Moult, Judy	Smartsuper	
Murphy, Terry	Stafford, John	
National Council of Women of Australia	Steel, Donald	
National Foundation for Australian Women	Sully, Peter	
National Information Centre on Retirement Investments Inc	Superannuation Commonwealth Officers Association	
National Seniors Association	Superannuation Information Centre Ltd	
National Tertiary Education Union	Swainston, John	
Nelson, Ken and Wilma	Tanswell, Karen	
Nichols, Peter	Taxation Institute of Australia	
O'Brien, P	Taxpayers Australia Inc	
Parish, Diana	Teece, Phil	
Parke, Melissa	Thorp, David	
Pascher, Fred	Towers Perrin	
Peterson, Vicki	Townsend, Tony	
Pettigrew, JS	Udell, Alan	
Phillips, Mark	UniSuper	
Piggott, Ruth	University of Auckland's Retirement Policy and Research Centre — Pension Reforms	
Police Federation of Australia	Wagner, Roy CS	
PricewaterhouseCoopers	Waldie, John	
Pritchard, Col	Ward, Dawn	
Prudames, Geoff		
Purdue, Bruce		

# Appendix D: Statistical analysis of submissions

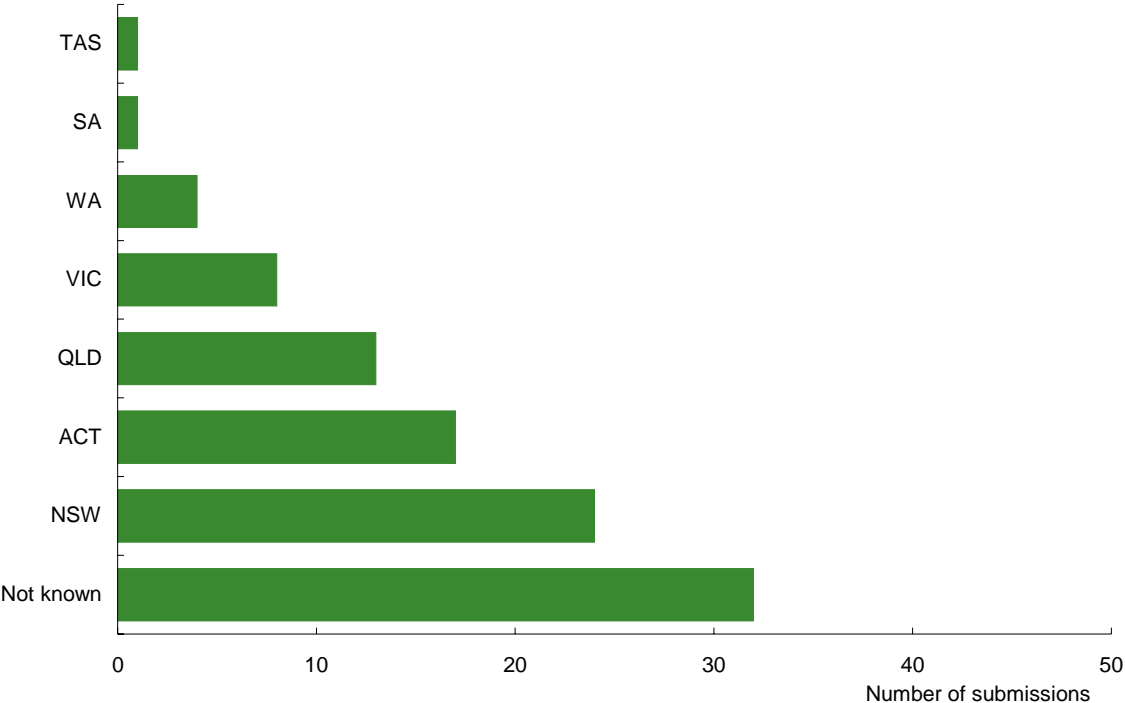
The Panel received around 160 submissions on the retirement income system, including approximately 100 from individuals. These submissions contributed to the development of this report.

A graphical analysis of submissions by source and issues raised is presented below. Submissions may have raised multiple issues within each category.

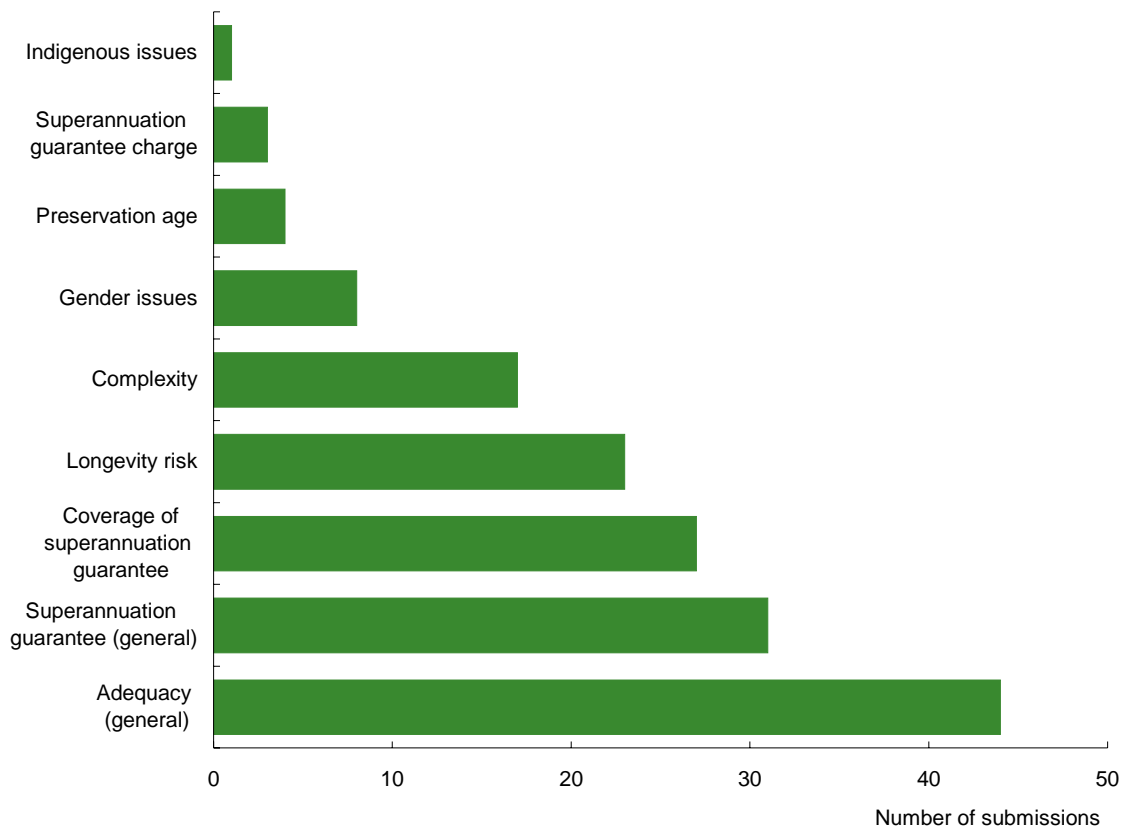
**Chart D.1: Gender of individuals making submissions**



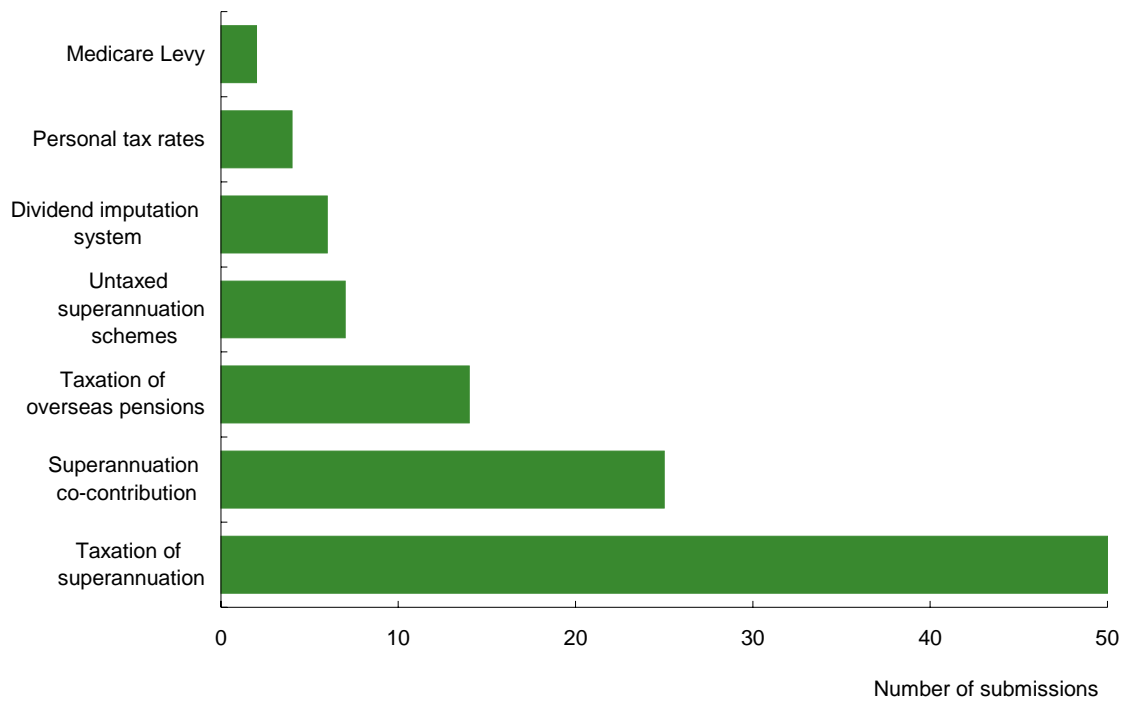
**Chart D.2: Location of individuals making submissions**



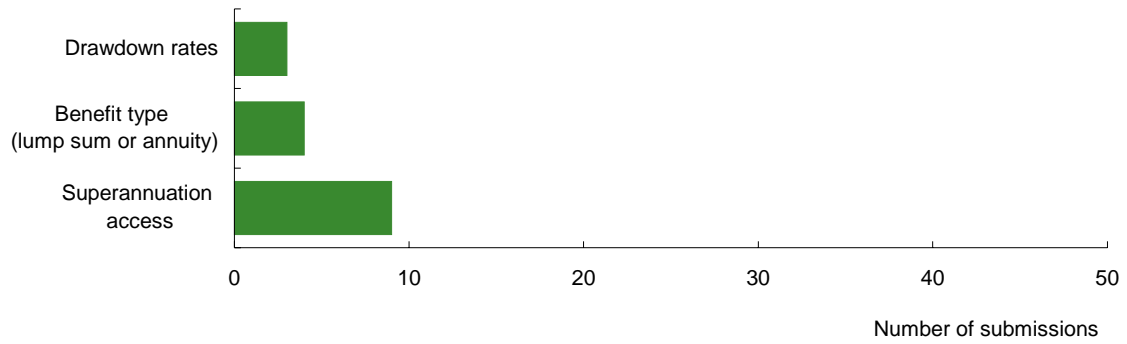
**Chart D.3: General superannuation system issues raised in submissions**



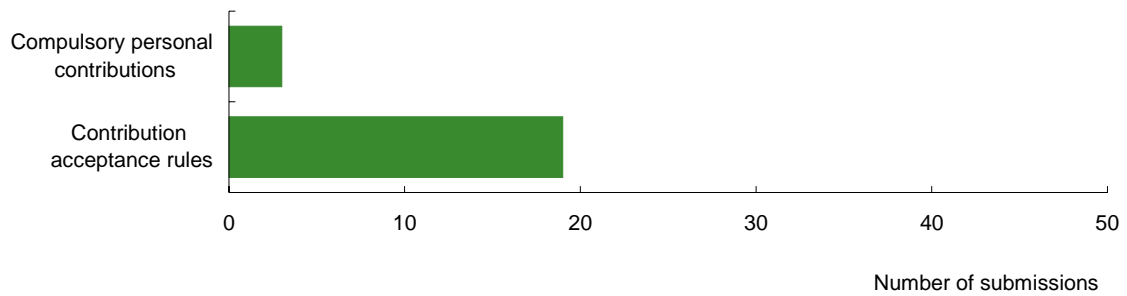
**Chart D.4: Tax and transfer issues raised in submissions**



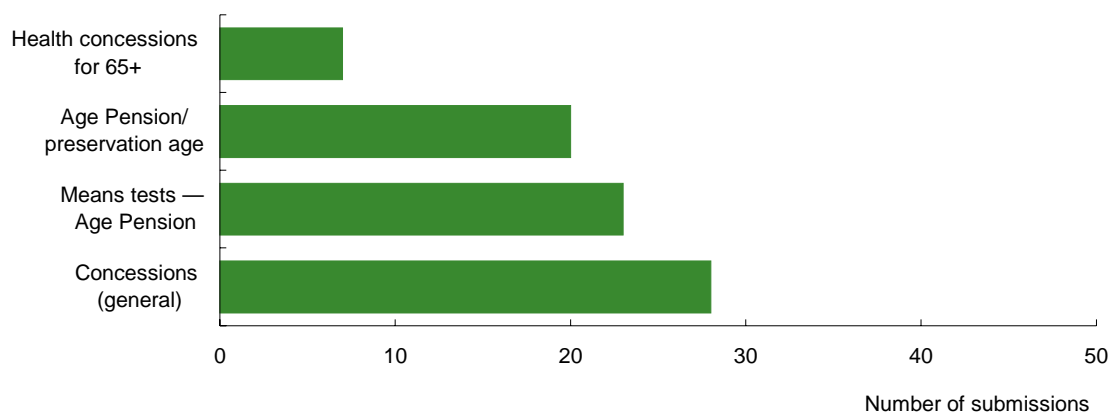
**Chart D.5: Superannuation benefits issues raised in submissions**



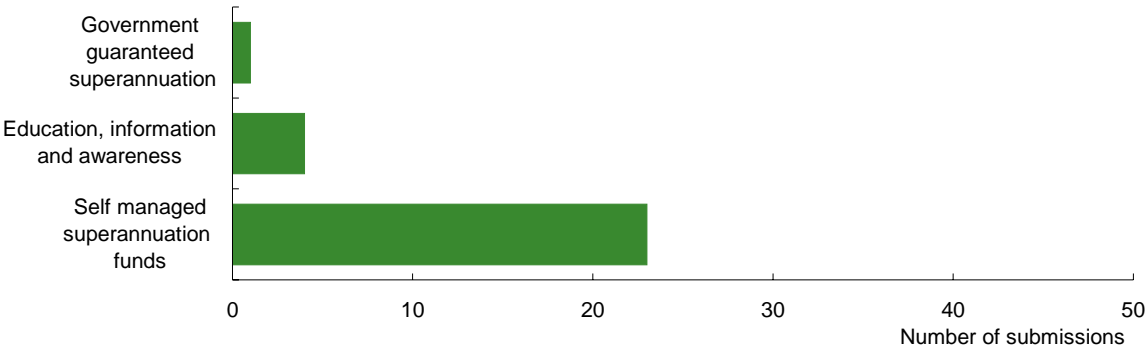
**Chart D.6: Superannuation contributions issues raised in submissions**



**Chart D.7: Government support for retirement issues raised in submissions**



**Chart D.8: Superannuation industry regulation issues raised in submissions**



## Appendix E: Key messages from submissions and public consultation

This report has been developed with the help of many people, in particular those who provided, at short notice, valuable submissions and/or participated in direct consultations with the Panel and Secretariat. The Panel's community forums have also offered valuable information on issues of concern to the community about the retirement income system.

The key themes from submissions and the community forums are detailed below.

### Retirement income system

An overwhelming majority of submissions from industry and individuals support the three-pillar structure of the retirement income system and consider that it should be maintained into the future. This sentiment was shared by participants at the Panel's community forums.

Submissions generally focus on refinements to the three-pillar structure to reduce complexity, enable individuals to better manage longevity and investment risk, and provide individuals with greater flexibility and choice.

Some submissions explicitly address the five objectives for the retirement income system presented in the *Retirement income consultation paper* – broad and adequate, acceptable, robust, simple and approachable, and sustainable. Of these submissions, the majority express strong support for the objectives.

### Adequacy

Several industry submissions recommend the government set an explicit adequacy goal. Many of these submissions support the use of the Association of Superannuation Funds of Australia's (ASFA's) 'modest but adequate' standard as a suitable floor for retirement incomes, and suggest the government provide incentives to encourage people to achieve ASFA's 'comfortable/affluent' standard. A small number of submissions state that government support above the 'comfortable/affluent' standard should not be provided. One submission proposes the establishment of an explicit 'Australian Minimum Standard of Living', guaranteed by social security payments.

Most submissions from individuals consider the Age Pension to be insufficient to provide an adequate income in retirement, and support increases of around 30 per cent in the current base rate. Several of these submissions propose tightening the Age Pension means tests to contain the costs of increasing the base rate. Some submissions advocate rolling allowances common to Age Pension recipients, such as the utilities, pharmaceutical and telephone allowances, into the base rate.

Submissions on the Age Pension means testing arrangements are mixed. Some recommend replacing the assets and income tests with a single income test, while others favour a single assets test.

A number of submissions, and several participants at the Panel's community forums, argue that contributions to superannuation should be increased. While a majority of industry submissions continue to favour an increase in the superannuation guarantee rate, several organisations have moderated earlier proposals to raise the superannuation guarantee rate, in light of the current global economic climate and revised economic modelling of retirement incomes.

In contrast, most individual submissions support maintaining the superannuation guarantee at 9 per cent on the grounds that an increase would impact adversely on their current living standards. One submission proposes that the rate be reduced for low income and middle income earners. One participant at the Panel's community forums suggested that the superannuation guarantee not be compulsory for younger Australians, who may have other expenditure/saving priorities.

Several submissions favour soft compulsion or mandating personal contributions to improve adequacy.

A large number of submissions from both industry and individuals emphasise the importance of encouraging voluntary saving and propose a range of additional incentives, including reducing superannuation contributions tax or boosting the superannuation co-contribution.

Many submissions highlight gaps in superannuation coverage and propose extending the superannuation guarantee to: proposed paid maternity and parental leave; unused long service leave; entitlements to wage payments; the self-employed; and carers. Several submissions also propose that the \$450 minimum superannuation guarantee threshold be abolished or applied to an individual's aggregate income, so that people who hold multiple low paying jobs qualify for superannuation guarantee contributions.

Some submissions suggest the government mandate the provision of end benefit projections by superannuation providers to assist individuals in monitoring how their savings are tracking against their goals. One submission suggests these projections allow for debt, as well as assets, to illustrate the consequences of carrying debt into retirement.

Several submissions express concern about the superannuation savings of women and suggest there is a need for specific retirement income concessions and policies for women.

A small number of submissions suggest the government adopt policies that would assist individuals in accessing the equity in their homes. For example, one submission recommends the establishment of a 'Home Renovation Service' so retirees can undertake essential home repairs that would enhance their ability to access equity release products.

Some submissions argue that improving superannuation funds' efficiency and investment performance is an important means of improving retirement income adequacy. They propose banning commissions on retirement income products as a first step towards this goal.

## Longevity

A large number of submissions, particularly from industry, focus on the implications of improved life expectancies for retirement income policy.

Several submissions express concern that the transition to retirement arrangements are not effective in encouraging people to work beyond Age Pension age. One submission proposes the introduction of a rebate for earned income, while another suggests providing an actuarially fair deferral of the Age Pension.

Most submissions note that the government provides insurance against longevity and investment risk through the Age Pension. Some consider that the government should encourage the market to provide deferred annuities or longevity insurance, such as through the issuance of CPI-indexed government bonds, or the removal of impediments to product innovation. Other submissions suggest the government have sole responsibility for the provision of these products, given its ability to pool risk. This view was shared by participants at the Panel's community forums. Participants at these forums favoured government provision on the grounds that private provision may give rise to high fees and charges, complexity and potential conflicts of interest.

Several submissions suggest the retirement income system should encourage individuals to take their benefits as an income stream. For example, one submission considers that this could be achieved through the exclusion of lifetime annuities from the calculation which determines the maximum bond payable for entry to an aged care facility.

Some submissions express concern about the funding of aged services into the future.

A small number of submissions recommend that the Age Pension age reflect projected improvements in life expectancy.

One submission argues proposals to address longevity risk should not disadvantage indigenous Australians, who typically face lower life expectancies.

## Ages

Submissions present mixed views on the Age Pension age, superannuation preservation age, and age from which tax-free superannuation can be accessed. Some submissions propose these ages be aligned. Other submissions support increasing the superannuation preservation and tax-free superannuation ages to encourage workforce participation and later retirement. Some submissions support the maintenance of a wedge between the superannuation preservation and Age Pension ages (for example, on the grounds that a wedge encourages individuals to boost their voluntary saving).

Several submissions argue that the Age Pension age be maintained at 65 years as an increase would disadvantage individuals who are unable to work (for example, manual labourers), notwithstanding the increase in their average life expectancy.

Some submissions suggest that individuals with a disability or caring responsibilities be able to access their superannuation from age 55 years, regardless of their income and asset levels.



Some submissions express concern over the inability of individuals aged over 75 years to contribute to superannuation. Several submissions propose the abolition of the superannuation contribution work test to enable individuals of any age to make voluntary contributions to superannuation. This view was shared by several participants at the Panel's community forums.

## Taxation

Most submissions favour the expansion of the existing superannuation tax concessions. In contrast, views at the Panel's community forums were mixed – some participants favoured the expansion of concessions, while others were of the view that all concessions should be abolished.

Submissions generally express strong support for the maintenance of tax-free superannuation payments for individuals aged over 60 years. Several submissions support the tax-free payment of all retirement pensions from age 60 years, including those paid from foreign sources and untaxed superannuation schemes. This proposal was also supported by several participants at the Panel's community forums. A small number of submissions suggest that death benefits paid from age 60 years should also be exempt from tax.

A number of participants at the Panel's community forums proposed that the taxation treatment of savings held outside superannuation be reviewed.

Many submissions express concern over the distribution of concessions, and suggest that low income earners receive a rebate of superannuation contributions tax. This view was shared by participants at the Panel's community forums. Some submissions suggest that the superannuation tax concessions for high income earners be removed, while others argue that they be retained on the grounds that they reduce Age Pension outlays.

A small number of submissions suggest that tax deductibility for personal superannuation contributions be made universal.

Several submissions discuss the superannuation contribution caps. Some submissions consider that the pre-tax contributions cap should be averaged to accommodate individuals with broken work patterns. Others suggest that the higher \$100,000 cap for individuals aged over 50 years be permanently retained, and support an increase in the cap for those aged under 50 years. One submission proposes the introduction of a lifetime contribution cap so people can make contributions when funds become available. Some participants at the Panel's community forums suggested that the caps be abolished.

A large number of submissions outline alternative taxation arrangements, many of which involve greater integration between the taxation, superannuation and social security systems. For example, some submissions recommend taxing superannuation contributions at an individual's marginal tax rate, while others propose limiting contributions to after-tax income, supported by the provision of a government co-contribution for low income earners.

## Regulation

A large number of individual submissions argue that the current regulatory arrangements for self-managed superannuation funds (SMSFs) are sufficient, and should not be broadened.

Several submissions recommend the government focus on enforcing existing SMSF compliance rules. Suggestions to improve compliance include: implementing a communication strategy to emphasise the importance of trustee obligations; encouraging SMSF trustees to consult specialist SMSF advisors; and imposing mandatory training courses on trustees who repeatedly fail to meet their compliance obligations.

One submission claims that increasing the reporting requirements for SMSFs would expand the role of superannuation specialists at the expense of members.

## Appendix F: Modelling retirement incomes

The projections presented in this paper are based on the RIMHYPO model maintained by the Treasury. This model produces retirement income projections for a hypothetical individual or couple, including all relevant combinations of life events, government policies and retirement income sources. It captures, in detail, the legislative structure defining the interactions between superannuation, taxation and social security legislation.

The growth assumptions used in this paper reflect long term trends.

- Inflation is 2.5 per cent per year, reflecting the mid-point of the Reserve Bank's medium term inflation target of 2 to 3 per cent, on average, over the cycle.
- Wages grow at 1.6 per cent per year in real terms, reflecting 30 year averages.
- Superannuation fund earnings are 6.5 per cent per year, reflecting 30 year averages.

The projections presented in this paper involve a range of additional assumptions. These assumptions are designed to provide a balanced view of possible outcomes for individuals. Actual outcomes could be higher or lower depending on the specific circumstances of the individual.

The base case is for a single person, who starts work in 2000 at age 30 years, and retires in 2035. A 35 year working life is an average working life for a primary earner, including periods outside the labour force (for example, study, care or travel).

- Many people will work more than the average. For example, a person who works full-time from age 20 years to age 65 years would have a 45 year working life. People who work longer are projected to receive higher replacement rates (see the projections for a person aged 20 years in 2008 in Table F.1).
- Many people will work less than the average. The paper includes analysis of the outcomes for an individual with a broken work pattern, who works less than the average for a primary earner. Chart 4.4 presents projections for a person aged 36 years in 2006, who works part-time between ages 36 years and 44 years, full-time between ages 45 years and 59 years, and part-time between ages 60 years and 64 years.
- Chart 5.2 and 5.3 present the impact of a 37 year working life, rather than a 35 year working life, to reflect the recommendations to increase the Age Pension age to 67 years and align the superannuation preservation age.

**Table F.1: Illustrative projected replacement rates under the Age Pension and superannuation guarantee for people with different periods in the superannuation system<sup>(a)</sup>**

Income as a proportion of AWOTE <sup>(b)</sup>	Replacement rate by individual's age (in years) in 2009 (per cent)				
	20	30	40	50	60
0.75	81.5	77.7	76.4	67.6	58.1
1.00	70.7	67.2	65.9	57.5	49.8
1.50	59.3	55.4	54.7	47.0	39.9
2.50	52.9	47.0	42.4	34.4	27.6

(a) A replacement rate compares an individual's spending power before and after retirement (that is, after tax is paid). For example, a replacement rate of 75 per cent would mean that an individual would be able to spend in a given time period \$75 in retirement for each \$100 spent before retirement. The projections are for people of different ages, who spend different proportions of their working life covered by the superannuation guarantee. The scenarios are: male aged 20 years now who enters the superannuation system now; male aged 30 years now who entered the superannuation system in 2003; male aged 40 years now who entered the superannuation system in 1992; male aged 50 years now who entered the superannuation system in 1992; and male aged 60 years now who entered the superannuation system in 1992. In all cases, the person retires at age 65 years and purchases a wage indexed life annuity. This implies that the person aged 20 years has a 45 year working life covered by the superannuation guarantee. The incomes used to calculate the illustrative replacement rates are deflated by the consumer price index to 2008-09 dollars. Actual outcomes will vary depending on factors such as workforce participation, investment performance, inflation, longevity and whether an individual accesses their superannuation before Age Pension age.

(b) AWOTE is average weekly ordinary time earnings and is around \$1,150 per week (\$60,000 per year). Around half of workers earn less than three-quarters of AWOTE.

Source: Treasury projections.

The base case assumes the hypothetical individual retires in 2035 and lives for a further 22 years (a total life expectancy of 87 years). This is based on Treasury projections of age-specific probabilities of death for each year of age, calculated using the 2005-2007 life-tables and various historical life tables published by the Australian Bureau of Statistics. The projections factor in improvements in mortality factors. Illustrative projections that assume a different point of retirement (Chart 5.2, Chart 5.3 and Table F.1) use the projected life expectancy at the point of retirement for the individual's age at retirement.

The base case assumes the person does not make any additional contributions to superannuation, beyond the superannuation guarantee. The exception to this is Chart 4.3, which presents replacement rates for an employee who salary sacrifices at the average rate for people in their age and level of salary and wage remuneration (including salary sacrificed amounts as remuneration).

The base case assumes the person does not access their superannuation before Age Pension age. The exception to this is Chart 5.3, which includes an alternative base case of an individual who accesses their superannuation from age 60 years (but has the same working life pattern). In this alternative base case, the individual is assumed to access their superannuation in a way that provides a steady income stream that increases in line with wages through the rest of their lifetime.

The base case assumes that individuals use their superannuation to purchase a hypothetical lifetime annuity, which is indexed by wages. This is different to the traditional assumption used in Treasury analysis, that the individual uses an allocated pension to draw down their savings over their expected lifetime. A lifetime annuity indexed by wages has the most comparable characteristics to the Age Pension. This assumption reduces replacement rates compared to the projections generated by the allocated pension scenario.

Replacement rates are generally calculated by comparing the average disposable income during a person's retirement to their disposable income in their final year of work. The

exception to this is Chart 4.4, which uses average disposable income through a person's working life, rather than disposable income in their final year of work. Average disposable income through the person's working life provides a better indicator of the lifetime living standards enjoyed by a person with a variable work pattern. Average working life income balances their income from years where they work a large amount with their income from years where they work less. By contrast, their income in their final year of work can be significantly above their average lifetime income (if they work more than average in their final year) or significantly below their average lifetime income (if they work less than average). Chart 4.4 also includes the base case scenario recalculated on the basis of lifetime, rather than final year, income to provide an appropriate comparison to the broken working life scenario.

The projections use consumer price inflation to determine the purchasing power an individual retains in retirement. Adjusting for consumer price inflation indicates whether an individual's real standard of living is maintained over time. Some groups argue that wages are a better indicator of living standards. Using wages reflects an individual's living standards relative to the (rising) living standards of workers, rather than their ability to purchase a particular set of goods and services. Table F.2 presents the base case replacement rate projections using both methodologies.

**Table F.2: Illustrative projected replacement rates under the Age Pension and superannuation guarantee, deflated by wages and consumer prices<sup>(a)</sup>**

Income as a proportion of AWOTE <sup>(b)</sup>	Replacement rate by choice of deflator (per cent)	
	Consumer Price Index	Average Weekly Earnings
0.75	73.4	60.9
1.00	62.9	52.1
1.50	51.6	42.6
2.50	41.1	33.9

(a) A replacement rate compares an individual's spending power before and after retirement (that is, after tax is paid). For example, a replacement rate of 75 per cent would mean that an individual would be able to spend in a given time period \$75 in retirement for each \$100 spent before retirement. The illustrative replacement rates are projected for a hypothetical single person who works for 35 years and retires in 2035. It is assumed that at age 65 years they retire and use their superannuation guarantee benefit to purchase a lifetime annuity. In the two scenarios, the incomes used to calculate the illustrative replacement rates are deflated to 2008-09 dollars by using the consumer price index and average weekly earnings. Actual outcomes will vary depending on factors such as workforce participation, investment performance, inflation, longevity and whether an individual accesses their superannuation before Age Pension age.

(b) AWOTE is average weekly ordinary time earnings and is around \$1,150 per week (\$60,000 per year). Around half of workers earn less than three-quarters of AWOTE.

Source: Treasury projections.

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