New ideas for Age Pension reform – discussion paper

By Geoff Dunsford, Actuarial consultant and Darren Wickham, Principal, Mercer

One major aspect of the Age Pension system is its impact on retirement incomes generally, and the needs they are required to satisfy. We are told that our “3 Pillars” system of compulsory private, voluntary private and state provision of retirement incomes is the envy of many countries. In practice, the “3 Pillars” have each developed independently. Rather than being the basis for a consistent and integrated retirement incomes policy, they make for an incoherent and dysfunctional whole. Moreover, we don’t actually have a retirement incomes system!

Our private superannuation system produces tax free lump sums at retirement (after age 60) from government legislated contributions as well as voluntary contributions. These are given to people who largely have no experience of handling such amounts. There is no compulsion or encouragement to convert any part of the benefit to a lifetime pension.

For many, lump sum superannuation can generate a “winning the lottery and how do we spend it” mentality – encouraged by promoters of retirement lifestyle products. When the excitement dies down, retirees are told they should manage the lump sums to support their desired living standards through perhaps 30 years or more of uncertain needs. And their financial advisers compound the uncertainty by recommending unstable investments which require regular review of mix and income drawdown, and reducing the benefits by levying fees for their obscure advice.

Arguably, it is irresponsible of a government to support a private superannuation industry which effectively requires retirees to have their benefits subject to all the risks of investment fluctuation, inflation and longevity, providing only a safety net in the form of the Age Pension.
We also have a means testing system (to limit the cost of the Age Pension and to target benefits to those that need them most) which is highly complex, discourages workforce participation, requires regular time consuming “customer” interviews, penalises inadvertent mistakes, and produces anomalous outcomes.

Perhaps the most outrageous anomaly is the opportunity for retirees to spend their tax free superannuation benefits (built up from tax advantaged contributions invested in tax advantaged funds), and then claim Age Pension benefits!

Even the superannuation tax advantages are highly distorted – in favour of those on higher incomes. Contributions tax *concessions* amount to a net 31.5 per cent for top earners, down to a negative 15 per cent for those on lowest incomes! The recent Better Super tax changes mean that the only taxes on benefits remaining are those on the poor (via the Age Pension means test). At each stage (contribution and benefits) the system is highly regressive.

**MAJOR REVIEW OVERTUE**

A major review of the Age Pension and related benefits is required because there hasn’t been one for many years.

Perhaps the most important issue is the effects of the ageing of the population leading to a projected increase in the cost of the Age Pension from 2.9 per cent GDP to 4.4 per cent GDP in 2047 (Intergenerational Report 2002 and update in 2007).

There are frequent comments in the media regarding the financial difficulties of many retirees. The means testing system is irritating for age pensioners, and provides confusing outcomes. These are more than adequate reasons for a new government to institute a review.

Dr Ken Henry has been asked to provide a report on the taxation system which will include the Age Pension. His comments on the Age Pension system are targeted for February 2009.

Ideally, we would like to suggest moving to a model which focuses on lifetime incomes and better integrates private superannuation and state funded benefits.

However, we believe that greater notice will be taken of our proposals if we adopt a less radical approach. The suggestions made focus on overall future government cost reduction, while eliminating current problems and anomalies. Many of the latter relate to the existence of means testing.

**OPTIONS FOR REFORM**

1. **Options to increase workforce participation**
   - Improve pension bonus system
   - Ignore personal exertion earnings in means test after Age Pension age
   - Increase the Age Pension age, i.e. the minimum age from which the Age Pension becomes available *(Note: need to align Disability, Unemployment and Age Pension benefits)*
   - Replace the Age Pension with a single “unable to work” Pension (towards abolishing retirement)
   - Other?

2. **Other options to reduce costs**
   - Increase compulsory superannuation contributions
   - Introduce measures to reduce “double dipping” *(i.e. spending superannuation and claiming the Age Pension)*
   - Tighten the means tests for the Age Pension
   - Use personal assets before claiming any Age Pension
   - Other?

3. **Options to simplify system**
   - Move to single means test
   - Index means test thresholds in line with pension increases
   - Exempt Age Pension from personal taxation
   - Incorporate supplementary cash support payments into Age Pension
   - Other?

4. **Towards elimination of means testing**
   - Abolish means test completely – universal Age Pension
   - Purchase the (balance of the) full Age Pension
   - Other?

**OPTIONS FOR REFORM – INCREASE WORKFORCE PARTICIPATION**

**Increase workforce participation rates**

The previous government suggested that its preferred solution to the challenge of an ageing population, and the increasing budget deficits projected in the second Intergenerational Report (IGR), was to implement policies designed to grow the economy more quickly and that the best way of doing that was to increase workforce participation rates.1 The new government has so far shown similar thinking.2

The IGR noted that workforce participation rates for the 15 to 64 age group had increased in the five years since the previous report. A further small increase is forecast over the next 40 years.

The report noted that Australia lies 12th in the list of 30 OECD countries – with UK, US and New Zealand ahead.

One particular group where increase has taken place in Australia is the “over 55s”. However, further significant increase should be possible.

The average workforce participation rate for those in the 55 to 64 age group is currently only 59 per cent (the IGR noted that the rate for New Zealand was over 70 per cent). Our average for the 65 to 69 group is 21 per cent. The employees in these age groups include a large number of part time workers. Arguably there is almost certain to exist significant underemployment in this group.

A major reason for the underemployment of over 55s is the clear favouritism of many employers to allocate full time jobs to younger applicants. While probably illegal in most cases, “ageism” of employers exists across a wide range of sedentary jobs which could readily be carried out by over 55s. And, of course, this situation is exacerbated by employers seeking to replace older employees with younger ones requiring lower salaries.
An arguably necessary way forward is for governments at all levels to take the lead. This could be pursued both through financing generous retraining schemes and actual employment of more over 55s in the public service.

Currently, many fit retirees perform voluntary work assisting the less fit in the community. Ideally, many of these jobs would be properly rewarded by the community through the Social Services budget. Apart from appropriately recognising the worth of such work, it would assist in the better understanding of the “true” work participation rates for the over 55s, and allocating the “correct” social security benefits.

**Increase Pension Bonus Scheme payments**

The Pension Bonus Scheme provides a bonus for those deferring their claim for the Age Pension, based on the level of pension to which they are entitled at the end of the period they have chosen to defer it.

Currently the Pension Bonus Scheme provides the following payments:

<table>
<thead>
<tr>
<th>Years deferred</th>
<th>Bonus (single person)</th>
<th>Percentage of pension payments “not received”</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$1,336.40</td>
<td>9.4</td>
</tr>
<tr>
<td>2</td>
<td>$5,345.50</td>
<td>18.8</td>
</tr>
<tr>
<td>3</td>
<td>$12,027.40</td>
<td>28.2</td>
</tr>
<tr>
<td>4</td>
<td>$21,382.10</td>
<td>37.6</td>
</tr>
<tr>
<td>5 or more</td>
<td>$33,409.50</td>
<td>47.0 (5 years)</td>
</tr>
</tbody>
</table>

This compares with the Age Pension for a single person of $14,216.80 per annum. Clearly the bonus is unattractive as a direct incentive to defer taking the Age Pension.

The scheme is of benefit to those who continue to work after reaching Age Pension age, and arguably it provides an incentive to do so.

However, the relatively poor level of benefit (miserly after one or two years, and reaching a maximum of around $33,000 only after five years for a single person then eligible for the full pension, compared with potential pension payments totalling over $71,000), the uncertainty of its amount for any person until the “end date” means test, and rather complex administrative procedures, have combined to generate a relatively poor take up rate.

A possible solution is to revamp the scheme to make it more attractive in terms of the amounts of bonus and its accessibility. Alternatively the reward for deferment could be in the form of an increased annual pension.

Another possible solution is to scrap the scheme, and focus on encouraging continued participation in the workforce by simply eliminating employment earnings from the means test.

**Eliminate personal exertion earnings from means test**

Another incentive to increase work participation is to ignore earnings from personal exertion in the means test.

An estimate of the cost of this to the Government for the current year is around $1 billion. This compares with the Budget estimate for total Age Pensions currently, of $24 billion. It could reasonably be expected that the economic benefit from the likely increase in the work participation rate would offset the relatively small cost of not assessing employment earnings.

The cost of eliminating wages and salaries from the Age Pension income test is much lower than abolishing the income test (or indeed moving to a universal pension).

Presently, most part rate pensioners have had their pensions reduced due to the income test (around 80 per cent), rather than the assets test. This group have assessable earnings from three main sources:

1. Deemed income and other income from investments
2. Superannuation
3. Wages and salaries

There is evidence that assessed income comes from the first two groups and not wages and salaries.

- Surveys suggest the most common form of income is from savings and investments usually from banks
- In June 2004, only 6.1 per cent of male and 7.4 per cent of female age pensioners were in the workforce. This compares with 32 per cent of all age pensioners who have their income reduced due to the income test.

- The main reasons for the fluctuating impact of the income test from year to year is the impact of savings and investment returns

Assuming around 126,000 age pensioners (20 per cent of the 630,000 income tested part rate pensioners) have had reductions due to personal earnings (with an average annual pension reduction of say, $3,300 each) – this suggests a cost of around $400 million for this group.

Further cost would arise in respect of those not currently receiving any Age Pension due to wages and salary (there were around 230,000 employees over the age of 65%, with 140,000 of these being age pensioners). If 75 per cent of this remaining eligible group of around 90,000 claim an average pension of say, $9,000 pa, this additional cost would be $600 million.

There would, of course, be no additional cost for those already working and not declaring their income to Centrelink!

Likewise, there would be no additional cost to the government for those currently receiving the Age Pension who decide to recommence employment!

**Increase the pension age**

Clearly, increasing the minimum eligibility age for the Age Pension would automatically increase the number of individuals “available for work” after age 65. At the same time there needs to be a reasonable rationale for doing so.

It would seem that there should be a sensible balance between the number of years that individuals are expected to work and pay taxes, and the number of years those who have been unable to fully provide for themselves are supported when they are unable to work.

Improving technology and increasing work efficiency have combined to provide the prosperity which has enabled retirees to continue to be supported as their number and longevity have increased.
However, at some stage, it seems reasonable to expect the above working/non working balance in a period of increasing longevity to be addressed by increasing the age to which people are expected to work if able to do so - i.e., the minimum age for eligibility the Age Pension, or the Age Pension age.

A number of countries are already pursuing this course, notably the UK, Germany and Japan.

A recent paper from CEDA, written by David Knox, noted this and suggested that Australia should also move its Age Pension age. Perhaps as expected, media journalists who write articles and are unlikely to personally need the Age Pension, supported the initiative, while reporters whose jobs are to find people to oppose new ideas, did so quite successfully, and the politicians ducked the issue.

**History of Age Pension age**

At the same time, it seems reasonable to project that the age at which people could be eligible for a state provided pension without a work test will be increased in the future.

The concept of retirement at age 65 (for males) has been accepted in most western countries since early last century.

The provision of a state funded age pension was introduced at a federal level in Australia in 1908 (first paid in 1909) for males and females from age 65. This was later lowered to age 60 females from 1910.

At that time the expectation of life of male retirees was 11.3 years. 40 years ago it had increased to 12.2 years, and is now 17.7 years (ignoring future expected mortality improvements). Current expectations are that it will continue to increase as a result of advances in medical science.

In 1908, the proportions of males born that were expected to survive to their 65th birth was 49 per cent. Today that figure is 85 per cent and rising.

The Age Pension age for females is currently 63, and is being increased gradually to age 65. This will apply to retirees from 2014. (For DVA pensions it is currently 58, and being increased to 60 over the same period).

The current expectation of life for 65 year old females is 21.1 years, compared with 12.9 years in 1908.

Arguably, the Age Pension age for males was fixed at age 65 in 1912 partly because many people of this age were no longer able to work. Today, only around 58 per cent of males aged 60 – 64 are currently in work, although many more would work if jobs were available to them. It seems likely that this position would also apply after age 65, at least for a few years. (Indeed some 28.5 per cent of those age 65–69 continue to work even though many would be eligible for the Age Pension.)

While not welcomed by those immediately affected, increasing longevity suggests that increasing the minimum age for the Age Pension is not unreasonable. Moreover, there would be a triple economic benefit. Government costs would be reduced, and more people would be net contributors to the economy, and they would increase their own superannuation for their eventual retirement. Arguably for some, there could be an increase in their well being and sense of “worth” or fulfilment.

**Need to provide advance notice of Pension Age increase**

However, these may not be sufficient arguments for the currently middle aged people who have been encouraged by superannuation industry promotions to plan for an active early retirement to enjoy their Autumn years, rather than later retirement.

Any increase in the Age Pension age will therefore need to be flagged many years in advance of its actual implementation. Apart from dealing with the likely general outrage, fanned by the press, it will be necessary to reassure people that the disabled and those unable to find work will not be disadvantaged.

**A reasonable Age Pension age**

Determining a reasonable Age Pension Age requires consideration of the “balance” between years working and years retired.

In 1908 when state funded retirement pensions were first introduced, this might have been 50 years working, to an average 11 years retired, for males. Currently it is more like 40 years working, (allowing for average years of tertiary education and years out of work), to at least 18 years retired for males.

It is accepted as reasonable that increasing prosperity should have allowed increased “retirement years” relative to “working years”. However, as discussed above, the increasing costs expected from the ageing population suggest that the current position should be reviewed.

The “work/retirement balance” principle for determining an appropriate retirement age might be considered as that age where the accumulation of a reasonable level of contributions provides sufficient proceeds to purchase an adequate private lifetime pension.

If we take 15 per cent of earnings as a possible reasonable level of contributions, and 65 per cent of gross pre retirement earnings as an adequate retirement income (as suggested by industry bodies, including this Institute, and supported by the Labor party), then we can develop an equation of value with the retirement age as the unknown.

To provide an example, we have assumed: seven per cent pa investment returns (including imputation credits from Australian equities) after expenses, together with four per cent pa salary inflation and the use of current “improving mortality” annuity rates, commencing employment at age 25 continuous full time working years thereafter, a $50,000 annual salary, and current lifetime annuity rates indexed at four per cent pa to maintain expected increases in living standards.

On this basis, we have found that age 70 currently provides the above suggested equivalence of value - across both sexes. Figure 1 shows the results for men, with the accumulated amounts in super versus the annuity values of 65 per cent of pre retirement earnings (the “Required Amount”).

A retirement age of 70 would provide a “years working to years retired” balance ratio of 45 to 13 on the assumptions made.

If age 70 is deemed to be an appropriate retirement age for those able to provide for themselves to ensure adequate retirement provision, then perhaps this is a reasonable age for the community to adopt as the Age Pension age, i.e. the age from which a state funded pension is paid to those with inadequate provision for themselves.
Affordability

While a logical calculation can be made for the Age Pension age, based on the accumulation of contributions and adequacy of lifetime income, it is still necessary for the government of the day to be able to justify the cost to taxpayers.

The cost will depend, amongst other things, on the number of workers and retirees at the time.

The next 10 to 30 years will see a significant ageing of the population arising from the high fertility rates prior to 1960 and the significantly lower fertility rates since time.

The proportion of “over 65s” is projected in the second IGR to increase from 13.4 per cent to 25.3 per cent over the next 40 years.

One estimate made by the ABS of the proportion of over 70 year old’s in 2047 is 21.1 per cent (compared with 9.5 per cent now). Bearing in mind the expected fall in the proportion claiming the Age pension, adoption of age 70 as the Age Pension age may result in the cost being “affordable”. It would be necessary to carry out more detailed calculations.

Moving to an increased Age Pension age

Whatever (new) age is selected as the likely desired Age Pension age in 2047, an announcement to this effect should arguably be made as soon as the decision/expectation is determined. This will ensure that those who will be impacted will have plenty of notice and be able to plan accordingly.

Moving to the targeted Age Pension age would be flagged as taking place over a period of years. If age 70 is the ultimate target, then phasing in can be made faster or slower depending on projected budget deficits. Two examples are:

<table>
<thead>
<tr>
<th>Age Pension Age</th>
<th>(1) Year</th>
<th>(2) Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>65.5</td>
<td>2020</td>
<td>2029</td>
</tr>
<tr>
<td>66</td>
<td>2023</td>
<td>2031</td>
</tr>
<tr>
<td>66.5</td>
<td>2026</td>
<td>2033</td>
</tr>
<tr>
<td>67</td>
<td>2029</td>
<td>2035</td>
</tr>
<tr>
<td>67.5</td>
<td>2032</td>
<td>2037</td>
</tr>
<tr>
<td>68</td>
<td>2035</td>
<td>2039</td>
</tr>
<tr>
<td>68.5</td>
<td>2038</td>
<td>2041</td>
</tr>
<tr>
<td>69</td>
<td>2041</td>
<td>2043</td>
</tr>
<tr>
<td>69.5</td>
<td>2044</td>
<td>2045</td>
</tr>
<tr>
<td>70</td>
<td>2047</td>
<td>2047</td>
</tr>
</tbody>
</table>

In this regard, it is worth noting that, if compulsory superannuation contributions are increased to 15 per cent of earnings, the additional contribution taxes would reduce the projected budget deficits. The phasing in of their implementation may well therefore be a factor in the determination of the phasing in of any increase in the Age Pension age.

Reframe Age Pension age – “soft compulsion”/blended approaches

There are several ways that state pension age can be increased that are not the simple ratcheting up of the minimum eligibility age. Blended approaches can be used where people are still eligible at 65 for some payment, but the default age is increased. Behavioural economics tells us that how the framing and description of choices impacts on individuals’ decisions (and also shows the people are often simply do not make choices and use default options – soft compulsion).

Some of these blended approaches have the advantage of allowing governments to argue that that people can still receive the Age Pension at 65.
Examples are:
a) Make the default age for pension commencement 75 (say) at current pension levels and offer an actuarially reduced pension for those commencing an Age Pension below 75.
b) Make the default age for pension commencement 75 (say), with an actuarially increased pension if taken from that age (or from ages between 66 and 75) and leave the pension at its current levels for those commencing at age 65.
c) Utilise one of the above options, but add further eligibility criteria that require a special application to receive an Age Pension below age 75 – such as disability grounds or impose explicit mutual obligation requirements (see below).

**Equalisation of Social Security benefits**

At the present time, Social Security benefits for those over 55 but under Age Pension age without jobs vary according to whether the person is disabled or simply unable to find work. Basic benefits per fortnight are $437.10 for those seeking work (Newstart Allowance). These compare with $546.80 for the Age Pension/Disability Support Pension.

Arguably all such “unemployed” people have similar living needs and should receive the same benefits (subject to means testing).

It is speculated that the discrepancy between the Disability and Newstart payments may help explain the very high levels of number of people receiving Disability Support Pensioners in comparison to the number receiving of unemployment benefits (around 21.5 per cent of the total male population aged 60-64 were in receipt of the Disability Support Pension in 2004 this compares with 2.9 per cent for the Newstart benefit).

This issue is exacerbated if/when the government increases the Age Pension age. While the basic benefits for the disabled are the same as those for the Age Pension, “seeking work” benefits are somewhat lower and “fringe benefits” vary between all three categories.

It is suggested that, in order to “sell” any increase in the Age Pension age to the community, the government will need to align all these benefits – at least for those over age 65 (63 for females).

**OPTIONS FOR REFORM – OPTIONS TO REDUCE GOVERNMENT COSTS**

**Increase compulsory superannuation contributions**

Many observers, including the IAAust, have noted that contributions of 9 per cent of earnings are unlikely to provide adequate retirement benefits for the vast majority of the population – even after including the Age Pension.

The Labor government, prior to 1996 proposed that the 9 per cent should ultimately be increased to 15 per cent, including 3 per cent paid by the employee. Various industry bodies have also suggested a 15 per cent target. A range of commonwealth public servants enjoy the benefits of a contribution rate of 15.4 per cent – this being the rate determined as equivalent to the cost of their previous, but now closed, defined benefit schemes. This rate is now proposed to be adopted for commonwealth politicians and judges.

Clearly, all these people consider that contributions of (at least) 15 per cent are required to provide a reasonable level of retirement benefits.

The results of extending the examples are as follows in Table 3. These results would seem to be much more acceptable as representing retirement incomes commensurate with pre retirement earnings – with a margin for the uncertainty of the outcome. (The higher after tax result for the 1 1/3 average earner, compared with the average earner, arises because the superannuation drawdown is not taxed, following the rather generous simpler/better super changes from 1 July 2007.)

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**Table 3.**

<table>
<thead>
<tr>
<th>Example: approx</th>
<th>2/3 average earnings</th>
<th>Average earnings</th>
<th>1 1/3 average earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross earnings</td>
<td>40,000</td>
<td>60,000</td>
<td>80,000</td>
</tr>
<tr>
<td>Less tax</td>
<td>(6,600)</td>
<td>(12,900)</td>
<td>(19,200)</td>
</tr>
<tr>
<td>After tax pre-retirement income</td>
<td>33,400</td>
<td>47,100</td>
<td>60,800</td>
</tr>
<tr>
<td>Projected benefit at age 65 – contribution rate of 9 per cent of earnings</td>
<td>196,000</td>
<td>296,000</td>
<td>395,000</td>
</tr>
<tr>
<td>15% of earnings</td>
<td>333,000</td>
<td>501,000</td>
<td>669,000</td>
</tr>
<tr>
<td>Non income producing, but assessable assets</td>
<td>30,000</td>
<td>45,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Superannuation income 6 per cent drawdown</td>
<td>19,980</td>
<td>30,060</td>
<td>40,140</td>
</tr>
<tr>
<td>Age Pension</td>
<td>14,368</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td>Means Test adjustment</td>
<td>(7,493)</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Total retirement income</td>
<td>26,879</td>
<td>30,060</td>
<td>40,140</td>
</tr>
<tr>
<td>Less tax</td>
<td>Nil</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td>After tax post retirement income</td>
<td>26,879</td>
<td>30,060</td>
<td>40,140</td>
</tr>
<tr>
<td>% of pre retirement income</td>
<td>– before tax</td>
<td>67%</td>
<td>50%</td>
</tr>
<tr>
<td></td>
<td>– after tax</td>
<td>80%</td>
<td>64%</td>
</tr>
</tbody>
</table>
If the compulsory contribution rate were increased to 15 per cent, then the projected cost of Age pensions in the year 2047 would be rather less than the 4.4 per cent GDP projected without such an increase.

The increase to 15 per cent could be phased in over a period of years. Alternatively, a system of “soft compulsion” could be introduced for some or all of the increase.

The above comments focus on a retirement age of 65. If the minimum eligibility age for the Age Pension were raised, the longer working lifetime could mean that a lower contribution rate than 15 per cent would produce adequate retirement benefits.

Double dipping
There appear to be mixed feelings in the community as regards the spending of superannuation money, and then, if it has run out, claiming the Age Pension.

Some take the view that, if they have personal funds at retirement which are insufficient to provide a lifestyle to which they aspire throughout their retirement, then it is perfectly reasonable to enjoy such a lifestyle until the funds are exhausted, and then fall back on the Age Pension. After all they have paid taxes throughout their working lives; hence they are, in principle, entitled to an Age Pension.

Others take the view that “double dipping” is a rort. Certainly, the generous superannuation tax concessions would reasonably be expected to result in retirement benefits which would be used to reduce government expenditure on Age Pensions. Arguably, whatever superannuation funds are available should last over the lifetime of the retiree. Only if the assets held and the income drawn fell below the means test thresholds would a part Age Pension be claimed.

The existence of a preservation age for superannuation benefits which is less the Age Pension age encourages the first approach above.

The superannuation preservation age is to be increased from age 55 to age 60 in stages over the period from 2015 to 2024. For this reason (and the availability of tax free benefits) many people see age 60 as a good target age at which to retire. This would allow enjoyment of some years of retirement while still healthy – and fitting the image of financial planning advertisements promoting the “cult” of early retirement.

Consequently, “double dipping” of retirement assets is subject to little restriction by the Government. The extent to which it causes Age Pension costs to be higher than if there were restrictions is uncertain. However, it seems likely that some measures to contain the effects will need to be considered as Age Pension costs rise with “baby boomer” retirements.

Possible measures to reduce double dipping
1. Require (some) superannuation assets to be used to purchase an indexed lifetime pension up to an income equal to the Age Pension.
2. Extend the tax on superannuation investment income and capital gains from assets supporting accumulation benefits, to income and capital gains from assets supporting pension benefits – except where the pension was a non commutable lifetime pension. This would raise annual revenue of around $2 billion currently, as well as encourage purchase of lifetime pensions.
3. Introduce a tax to be paid on superannuation withdrawals in any year over a prescribed maximum percentage of account value at the beginning of the year. The maximum percentage would increase with age.
4. Encourage the purchase of the Age Pension (or balance up to the full Age Pension in the case of those entitled to a part Age Pension). This could be pursued through the purchase from a life company where the Government provided some support for the inflation risk (and possibly the longevity risk). Alternatively the Government could accept the purchase directly.
Tighten the means tests

Over the past decade, the means tests have been relaxed in a number of ways. The main ones were reducing the “taper” rate under the income test from 50 per cent to 40 per cent (in 2000), and the availability of a more generous assets test treatment for complying pensions or annuities (in 2005).

From 1 July 2007, the (previous) government legislated a further relaxation of the assets test taper to effectively permit home owning couples with up to $825,500 (excluding the family home) to be able to claim a part Age Pension. (Previously the top threshold was $536,000.) The new figure was increased to $856,500 from 1 July 2008. The corresponding top threshold for singles is $540,250.

Arguably, these initiatives represented Liberal/National party policy in wishing to maximise the incentives to voluntarily save for retirement (or minimise disincentives).

An alternative view would be that providing part pensions to those with more than $500,000 represents “middle class welfare”, and the money could be better spent on the genuinely disadvantaged.

Restore “taper” to 50 per cent

To save costs, the incomes test “taper” could be restored to 50 per cent. (Arguably, this would make it more consistent with the “taper” under the Assets test, which, assuming an investment earnings rate of 7.8 per cent per annum, is 50 per cent of income generated).

This move could be softened by a decision to scrap income tax on the Age Pension. In practice, few pensioners pay any income tax, so that the Government could claim that, after the changes the maximum effective rate of “tax” (i.e. including means test taper) on marginal income is just 50 per cent.

Estimated savings are $500m (in 2006-07 dollars)

Reduce assets test thresholds

The assets test thresholds are inconsistent with those for the incomes test. A single homeowning retiree can have assets of $171,500 before losing any Age Pension. It is believed that, for such people, non income producing but assessable assets tend to represent about $30,000 to $40,000 of this. This leaves say, $140,000 earning say, 6 per cent pa – ie producing an income of $8,400 pa.

The equivalent minimum threshold under the incomes test, of $3,588, appears inconsistent with this. It may be considered reasonable therefore, to reduce the assets test threshold to from the $171,500 to around $3,588/.06 + $40,000 = approx $100,000.

The equivalent threshold reduction for couples would be from the current $243,000 to $6,240/.06 + $70,000 = $174,000.

Estimated savings are more than $400m (in 2006-07)

Use personal assets before claiming any Age Pension

A possible approach to tightening means testing is to require the use of personal assets in excess of the current asset threshold for a full Age Pension, to fund retirement needs before access to the Age Pension is permitted. That means that no part Age Pension would be available. Once personal assets had fallen below that threshold ($171,750 for single home owners and $296,250 for single non homeowners), the Age Pension would be available – and payable at the full rate.

Undoubtedly such action would be unpopular – although perversely it appears to be encouraging double dipping! It may have a similar impact to simply increasing the Age Pension age.

To avoid actually spending personal assets, the retiree could have the option of purchasing a lifetime annuity/pension. Consequently, in conjunction with this alternative, the proposal could possibly result in reducing the cost of double dipping while simplifying means testing – as well as tightening the means test.

Estimated savings $750m per annum (in 2006-07 dollars)

AGE PENSION AND “FRINGE BENEFITS”

Fringe benefits

There are a plethora of concessions and allowances available to Age Pensioners (and in some cases, to other Seniors), provided by the federal and state governments.

Many of these “fringe benefits” are paid to assist meeting specific types of expenditure – e.g. telephone costs, council rates, water rates.

Certain of the federal government “fringe benefits” are paid as “supplementary cash” support to all Age Pensioners. These are:

Table 4.

<table>
<thead>
<tr>
<th>Current rate for single pensioners, and total for couples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pharmaceutical allowance</td>
</tr>
<tr>
<td>Utilities allowance</td>
</tr>
<tr>
<td>Seniors bonus</td>
</tr>
</tbody>
</table>

Arguably these could be incorporated into the Age Pension to provide a single fortnightly pension payment. Without other changes, this would have the effect of increasing the thresholds permitting a part Age Pension slightly, while providing existing pensioners with the same income. However, the cost would be small, as the number of additional pensioners would be small and they would only be receiving a small part pension.

This would represent some simplification of the system. The move would also provide better certainty of payment for pensioner budgeting purposes.

For the purposes of comparisons with standard of living measures in this paper, Age Pension amounts are shown inclusive of these supplementary cash” allowances.

Retention of allowances separate from Age Pension

It is appreciated that the federal government may wish to retain some flexibility by keeping the allowances separate from the Age Pension, e.g. they can be easily varied, or eligibility rules can be changed, on a year to year basis.

Indeed, the view could be taken that eligibility for the allowances should be means tested so that full allowances are only paid to pensioners with minimal resources receiving the full Age Pension. Those with sufficient resources that they only qualify for a part pension, could have their allowances reduced in the ratio of their part pension to the full pension.
This would enable the government to increase the nominal total value to focus the benefit on the poorer pensioners without any impact on the current government budget.

**Rent Assistance**

Current maximum levels of Rent Assistance are $53 per week for single pensioners and $47 for couples (in total) – yes, less for couples! (FaHCSIA have advised that this is due to their attempting to follow the policy established in 1993, whereby “single pensioners and couples who are wholly reliant on social security payments pay a similar proportion of income on rent before qualifying for Rent Assistance”).

These maxima are woefully inadequate when compared with current private market rents. Even in outer suburbs of Sydney, rents for one bedroom apartments near shops and public transport are around $180 per week.

Homeowners incur some housing costs. Consequently it is reasonable to assume that some level of this in included in the Age Pension and that this should be allowed for in determining maximum levels of Rent Assistance, (perhaps after also allowing for council and water rate rebates available to homeowners). However, it is clear that significant increases are required to provide a standard of living for renters approaching that for homeowners age pensioners.

To limit government expenditure, revised levels of Rent Assistance could be targeted at those most in need. For a part age pensioner the nominal Rent Assistance available could be reduced in the ratio of the part pension to the full pension.

**ABOLISH MEANS TEST COMPLETELY – UNIVERSAL AGE PENSION**

**Proposal**

- An Age Pension paid to all eligible residents.
- No assets tests or income tests apply (i.e. a universal pension)
- Age Pension exempt from income tax (just like super benefits)
- Cost is met from general revenue which is augmented by extending superannuation tax to investment income on pension assets, and removing the CGT discount under superannuation, personal income and trusts tax regimes.

**Why a universal Age Pension?**

Many of the reasons why the Age Pension fails to meet its objective of being an efficient pillar of Australia’s retirement income system relate to the means tests.

The means tests distort savings and investment behaviours, are administratively costly, and discourage workforce participation. They can make planning for retirement very difficult.

Australians accept universally provided benefits for health needs. Australia’s healthcare system, Medicare, is universal and not subject to means testing. This is accepted (and indeed is highly thought of) by Australians despite benefits being available to the wealthier members of the community. This arrangement is perceived to be reasonable because there is a fair tax arrangement to fund the benefits.

Due to the tax arrangements (including the notional “Medicare Levy”), wealthier people contribute more on a dollar basis to funding Medicare, but the benefits are the same for everyone.

The proposals in the section are consistent with this philosophy of fairness achieved through taxation.

**This proposal for universal pension is different**

There have been other proposals for a universal Age Pension in Australia. In fact, Australia has twice had legislation pass through parliament for a contributory social insurance scheme which included it. In 1929, the legislation was never proclaimed (following a change of government). In 1938, the scheme commencement was twice postponed and then finally lapsed in 1939. In addition, in 1975 the Whitlam government abolished the means test for those over age 70; however, an assets test was reintroduced in 1985.

Many other OECD countries’ contributory universal social insurance systems are essentially salary based defined benefit schemes.

In the 1990s the IAAust proposed making the Age Pension universal and imposing a tax on pensioners’ income. (1994 IAAust submission to Senate Inquiry).

This proposal is different:

- The cost of the universal pension is met from general consolidated revenue.
- There are no complex additional tax arrangements specifically to clawback the universal pension from individuals.
- Therefore the proposal is simpler from the pensioner’s perspective.
- The measures to increase consolidated revenue provide tax revenue largely from wealthier people – both those currently in employment and superannuation fund pensioners.

**How much does abolishing the means test cost?**

According to the (then) Department of Family and Community Services, the means test saved the Government around $6–$7bn in respect of Age Pensions in 2002.14 ASFA recently stated that abolishing the means test would cost in excess of $6.5 billion a year.15

Based on the latest published statistics (2006-07)16:

- Around 705,000 people of Age Pension age (who are eligible residents17) are not currently receiving any pension (missing out on an average pension amount of $12,400).
- Around 780,000 people are receiving a reduced age pension due to the income or assets tests. On average the reduction in the pension is around $3,300 per annum.

If the Age Pension was paid in full to these two groups, the increased expenditure in 2006–07 would have been in the order of $11.3bn higher (around 1.1 per cent of GDP). This figure needs to be reduced as some of the extra expenditure has already been incurred with the Better Super changes (increasing the assets test taper rate from 1 September 07). The Better Super impact is around $0.7bn18, therefore the cost of a universal Age Pension under the current rules would be around $10.6bn (1.0 per cent of GDP).
In 1998, Treasury’s RIM group did some work forecasting the additional cost of a universal Age Pension. The results were that the additional cost would be around 0.8 per cent of GDP in 2010–11 rising to 3.5 per cent of GDP by 2050.

We believe that Treasury’s projections used in the Intergenerational report may overstate the impact of means testing in the future due to the way thresholds are assumed to be indexed. So the impact in our view is likely to be less than that 3.5 per cent of GDP previously forecast by Treasury.

The cost of removing the means tests is likely to vary by age group. The table below shows the number of Australians at 30 June 2004 at different ages receiving the Centrelink pension, Veterans pension, and not receiving any pension.

### Funding the reform – increasing tax on investment income and capital gains

A combination of increases in taxes on investment income and capital gains is proposed to fund the extra $10.6 billion in Age Pension expenditure. The tax increases proposed are:

- Remove the capital gains tax discount on superannuation funds ($1.5 billion).
- Tax the assets of superannuation pension assets in the same way as assets in the accumulation phase ($3.0 billion).
- Remove the capital gains tax discount under the personal income and trusts regimes ($6.9 billion).

All figures above are in 2006-07 dollars.

The additional tax revenue from these measures is likely to grow faster than GDP and therefore be effective (at least partly) in meeting the growth in Age Pension expenditure as a result of removing the means test and the ageing of the population.

Any future Age Pension expenditure not covered by these tax changes could be reduced via the increase in Age Pension age.

It is suggested that this approach of taxing investments has advantages over alternative approaches to funding the universal Age Pension – such as having a specific Age Pension social security levy on salary and wages or taxing the Age Pension paid to middle and higher earners more heavily.

- It is much simpler to explain;
- Provides an incentive for continued workforce participation (zero marginal tax rates – compared with an approach of taxing the Age Pension which has employment disincentives);
- It improves integration of state funded and privately funded retirement benefits;
- It is administratively efficient;
- It is more progressive (taxing asset rich);
- It is better for transitional arrangements as many of the beneficiaries of the change will contribute tax revenue towards receiving the Age Pension. (A wage based levy would mean current rich retirees would not contribute to the cost of receiving their Age Pension); and
- A wage based social security levy to fund both current and future Age Pensions would be very high (around 6 per cent or 7 per cent of pre tax wages).

Isn’t this just replacing one tax with another?

The assets and income tests can be thought of as a tax on private pension income. This proposal is essentially replacing the means test “tax” with other taxes – so what’s the point?

The problem is they are a highly inefficient and behaviour distorting tax. Replacing them with an administratively simpler tax would generate better economic outcomes in terms of economic growth (due to higher workforce participation and less distorted investment decisions) and equity.

“Better super” (originally called “simpler super”) represented a tax cut on retirement income for the wealthy. This left the only tax on superannuation retirement income being the Age Pension means tests. This proposal restores fairness to the taxation of retirement income.

Removing the means tests would also improve adequacy for the large portion of people projected to receive a part Age Pension. It would also remove the concept of “double dipping”, and would help people focus on making their superannuation last throughout retirement.

The removal of the assets and income tests would also mean that

<table>
<thead>
<tr>
<th>Age group</th>
<th>Centrelink Age Pension</th>
<th>Veterans Pension</th>
<th>No income support</th>
<th>Total population</th>
<th>% Receiving income support</th>
</tr>
</thead>
<tbody>
<tr>
<td>Female only 63 &amp; 64</td>
<td>127,004</td>
<td>2,599</td>
<td>38,845</td>
<td>168,448</td>
<td>77%</td>
</tr>
<tr>
<td>65–69</td>
<td>510,525</td>
<td>17,645</td>
<td>218,230</td>
<td>746,400</td>
<td>71%</td>
</tr>
<tr>
<td>70–74</td>
<td>472,315</td>
<td>27,524</td>
<td>128,561</td>
<td>628,400</td>
<td>80%</td>
</tr>
<tr>
<td>75–79</td>
<td>364,732</td>
<td>76,812</td>
<td>108,156</td>
<td>549,700</td>
<td>80%</td>
</tr>
<tr>
<td>80–84</td>
<td>206,040</td>
<td>124,435</td>
<td>54,325</td>
<td>384,800</td>
<td>86%</td>
</tr>
<tr>
<td>85–89</td>
<td>118,667</td>
<td>41,679</td>
<td>33,354</td>
<td>193,700</td>
<td>83%</td>
</tr>
<tr>
<td>90 or more</td>
<td>70,329</td>
<td>8,723</td>
<td>22,848</td>
<td>101,900</td>
<td>78%</td>
</tr>
<tr>
<td>Total 2004</td>
<td>1,869,612</td>
<td>298,416</td>
<td>604,320</td>
<td>2,773,348</td>
<td>78%</td>
</tr>
<tr>
<td>Total 2007</td>
<td>1,953,686</td>
<td>252,966</td>
<td>741,069</td>
<td>2,947,721</td>
<td>75%</td>
</tr>
<tr>
<td>Difference 2004 to 2007</td>
<td>84,074</td>
<td>(-46,450)</td>
<td>136,749</td>
<td>174,373</td>
<td></td>
</tr>
</tbody>
</table>
people would be able to better utilise their home in their retirement savings (as people are penalised by the assets and income test if they “down size” their home and invest the proceeds).

Many economists consider that capital gains are simply another form of investment income, and to treat them differently from other income has distorting effects (as well as inviting creation of avoidance mechanisms). It would be reasonable however, to allow for “averaging” of the marginal tax rate to be applied following sale, over the period the asset has been held.

Transition – Options

a) Remove means test for older people first: say, remove means tests for all those over age 75 from 1 July 2010, gradually reduce age where means test ceases to apply over 10 year period. As shown above, this would have very little immediate impact as the percentages of retirees already reliant on income support over age 75 is very high – and would allow a long lead time to scrap the capital gains tax discounts.

b) Fixed Future Transition Date for all: put tax measures in place now and remove means test for all people over Age Pension age from 1 July 2012.

c) Blend – during the transition period reduce impact of age pension means test by steadily increasing income and asset thresholds.

Other issues

Rent Assistance

Issues that would need to be considered in implementing a universal Age Pension is whether Rent Assistance should be given to the relatively wealthy that would become eligible for the Age Pension for the first time, and whether those who have a part Age Pension should receive the full amount of Rent Assistance.

One possible approach is to retain the means test for Rent Assistance. The amount paid could be reduced for those whose assets or income lie between the thresholds for a part (non Age) Pension.

Another approach may be to provide Rent Assistance on a non means tested basis. While around 30 per cent of current Age Pensioners are not home owners, only around 11 per cent claim Rent Assistance. Accordingly the cost should not be excessive. It may be argued that wealthy non home owners may unfairly benefit from this (e.g. if they have an investment property). However, the following points can be made:

- Under this proposal, they will be paying higher taxes – full rate on CGT and 15 per cent on investment income if this is in a super fund, including on pension assets (higher if not in super).
- People have emotional reasons for living in their own home; “gaming” the system to secure more Rent Assistance is unlikely a major incentive for selling.
- In any case, if a pensioner wants to sell a primary residence (which is exempt from tax) to claim Rent Assistance, they will be investing the money somewhere. They will then be paying tax on their investment income and capital gains in the future at the proposed revised rates. The larger the investment, the larger the tax paid (likely to be more than covering Rent Assistance).

Fringe benefits

The “fringe benefits” (e.g. Commonwealth Health Seniors Card) would be available to more people than is currently the case. This will have an extra cost. However, it is not likely to be excessive as many self funded retirees get them now.

Notes on capital gains Tax

The 1999 Ralph review put the following arguments in favour of cutting capital gains tax:

- It would encourage a greater level of investment, particularly in innovative, high growth companies (particularly venture capital).
- It would substantially improve the operation of Australian capital markets.
- It would help support a stronger investment culture amongst ordinary Australians.
- Other countries have more favourable tax regimes and competition for capital will become more intense. Failure to attract investment funds will mean lower levels of economic growth.
- A (then) recent Financial Review article argued that taxes on capital were “productivity sapping”.

The following observations can be made:

- There is little evidence that there has been a substantially higher level of venture capital and growth investments following the introduction of the CGT discount in September 1999. The question has to be asked has the Government received “bang” for its tax expenditure “buck” (could the cumulative $35 billion in tax expenditures since 1999 have been better spent elsewhere?).
- The improvement in operation of capital markets is difficult to prove or disprove.
- Super funds have not changed their investment behaviour following the introduction of the discount.
- The main beneficiaries of reduced capital gains tax are wealthy individuals without changing behaviour.
- The discount played a destructive role in accelerating a housing bubble (through the CGT discount applying to investment properties).

PURCHASE THE (BALANCE OF THE) FULL AGE PENSION

Introduction

Arguably, most people favour steady income in their working lives (in real terms) – or at least a significant part that is steady and meets needs. When “one off” expenditure is contemplated, this can be met from savings – or borrowing, following which adjustment is made to future disposable income to allow for repayments. Arguably, this approach to managing personal finances would continue into retirement. Except, of course, “one off” expenditure can be met from lump sum superannuation. The problem is that managing a lump sum to provide a steady income and meet “one off” expenditure is rarely an attribute of retirees. And can be made more difficult when there are family and peer group pressures (supported by advertising directed at retirees) to meet a succession
of “one off” expenditure “needs” and spend too much prematurely. Retirement can be as long as 30 years or more, with uncertainty as to lifestyle and health needs and desires over this period.

If it is accepted that, for most people, the ideal retirement income is one that is level in real terms and adequate throughout retirement, some measures need to be taken to wean Australians off the “lump sum” mentality and (re)introduce a culture of retirement pensions.

Government assistance in the form of issuing more long term indexed bonds, and longevity bonds (which broadly reinsurance increasing longevity risks), would enable life companies to offer more attractive indexed lifetime annuity terms. But this may not be enough for voluntary purchase: investment would still be based on fixed interest assets where the returns often appear low, and some conservatism would continue to be needed in determining the terms.

The Government, having access to future taxation revenue, could offer more generous terms than life companies for the purchase of pensions which could still be fair as between generations of taxpayers.

**Purchase of the Age Pension from the Government**

As a start to developing a retirement pensions culture, self funded retirees could be given the opportunity of purchasing from the Government a pension equal to the Age Pension – or the balance up to the full amount for those currently entitled to a part Age Pension under the means tests.

**Government incentive**

Currently, around 70 per cent of those reaching age 65 claim a part or full Age Pension. This compares with around 85 per cent for those now age 85. To some extent this reflects the greater saving by the more recently retired. But increasing reliance on the Age Pension with advancing age tends also to occur as a result of the other income of many retirees not keeping pace with inflation, or assets being spent.

The Intergenerational Report update issued in 2007 commented that “the proportion of the eligible age group not receiving any Age Pension is projected to rise [only] slightly” [our emphasis]. With rising superannuation benefits expected to result in some fall in those claiming the Age Pension immediately on reaching the eligible age, this comment implies that the increasing incidence of claiming with advancing age is expected to continue.

Encouraging self funded retirees to use part of their assets to purchase the Age Pension would reduce the potential problems of many at later ages, and make them simpler for the Government to manage.

**Objectives of the proposal**

1. **To enable self funded retirees to purchase an indexed lifetime pension with part of their wealth on an attractive basis.**

   This represents a desire to satisfy a general need in the face of apparently unattractive products available from life companies.

   This is clearly a useful objective. Purchase of the Age Pension as a lifetime annuity should satisfy this objective. It should also be capable of easy implementation – either by the Government providing the purchased pension directly, or providing reinsurance for life offices willing to participate in such provision in the form of an annuity.

   Purchase of the Age Pension in these circumstances would be an “investment”. As such, if some or all of the retiree’s remaining investments were consumed over time, the retiree could ultimately become eligible for a Social Security part Age Pension as well! This outcome could be considered as less than optimum.

   Pursuit of two further objectives could therefore be considered in order to assist meeting the needs of the Government and individuals in a climate of increasing longevity.

   2. **To limit the Government’s potential financial burden when increasing numbers of self funded retirees with increasing longevity exhaust their investments.**

   This objective may be satisfied by making the purchase the securing of a full Social Security Age Pension, rather than simply an investment in an annuity. In the case of existing part Age Pensioners, the purchase of the “balance” would result in their becoming full Social Security Age Pensioners.

   3. **To give self funded retirees the opportunity to ensure that, throughout their lives, they will never need to apply for a means tested Age Pension.**

   The inclusion of the third objective satisfies the likely further desire of both the Government and many retirees – to avoid the messy processes and embarrassments to be endured in means testing.

   Selling a Social Security Age Pension (or balance of the full pension for part age pensioners) on this basis also has the advantage for the Government in utilising the same ongoing administrative procedures as those required for paying the pension to those currently eligible as a result of need – but without the means tests.

**Table 6.**

<table>
<thead>
<tr>
<th>Annuity / Pension purchased</th>
<th>1. Annuity market price</th>
<th>2. Pension – possible Government price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Male 65</td>
<td>$14,368 pa</td>
<td>$289,000</td>
</tr>
<tr>
<td>Female 63</td>
<td>$14,368 pa</td>
<td>$344,000</td>
</tr>
<tr>
<td>Couple: male 65 female 63</td>
<td>$23,904 pa</td>
<td>$550,000</td>
</tr>
</tbody>
</table>
Cost – investment

The following numbers compare:

1. Estimates of the current market cost of purchasing annuities from a life company equal to the Age Pension, assuming 4 per cent per annum future increases, with

2. Possible purchase prices which might be acceptable to the Government for future payment of the Age Pension (ignoring the Health Card and other “fringe” benefits).

Life companies must adopt conservative assumptions as regards future investment returns. The Government could take the view that a reasonable investment return to be assumed was more in line with that targeted for the Future Fund – i.e. inflation, say 2.5 per cent, + 5 per cent = 7.5 per cent per annum, rather than a long term bond return of around 6 per cent pa necessary to be assumed by life companies. The above Government numbers assume this, together with 4 per cent per annum expected increases, 5 per cent of pension payments for expenses, ALT 2000-02 mortality less five years for selection, and improving longevity.

Adoption of a basis involving a future long term investment return assumption would have the advantage of requiring relatively infrequent changing of purchase price rates.

Social Security Aspects – Fringe Benefits

Eligibility for the Age Pension brings with it the availability of Pensioners Concession Card benefits.

It would be reasonable for buyers of the Age Pension to also receive these “fringe benefits”. This would fit well with the objectives of the initiative, and simplify administration.

Of course, those eligible for a part Pension and considering buying the “balance” will already be receiving the “fringe benefits”. This would fit well with the objectives of the initiative, and simplify administration.

Examples

The following examples in Table 7 provide some indication of possible utilisation of an option to purchase the Age Pension (including pension supplement, paid since 2000 following introduction of the GST, and pharmaceutical allowance). The purchase price is assumed to be determined on the same basis as adopted above. For simplicity, it is assumed that there is no employment income, and, in conducting the means tests, the assets test is the most stringent in each case. All assets are superannuation, and the account based pension drawdown assumed is 6 per cent per annum for single lives and 5 per cent for couples. All numbers are in dollars and pensions are per annum.

Comment

Of course, incomes in future years should be compared as well as those suggested for the first year. However the income drawn from the superannuation assets is likely to fluctuate and may not last throughout life. Importantly, the Age Pension component of the incomes shown is guaranteed for life and will increase with inflation.

Capital protection

The Age Pension represents a lifetime annuity without any guaranteed payment period or benefit on early death.

Many purchasers of such an annuity would be concerned over “their” “loss of capital” on early death. It is suggested therefore that purchasers of the Age Pension be given the option of including “capital protection”, i.e. in the event of death, the excess of the purchase price over pension payments received be payable to the purchaser’s estate.

It is estimated that for a male age 65, this should increase the cost by only about 7 per cent, and less for females and couples.

Table 7.

<table>
<thead>
<tr>
<th>Total assets</th>
<th>Eligible Age Pension or part pension</th>
<th>Pension to be purchased</th>
<th>Cost of pension purchased</th>
<th>Balance of assets</th>
<th>Income Before purchase</th>
<th>Income After purchase</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Single Male Age 65</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>600,000</td>
<td>Nil</td>
<td>14,368</td>
<td>240,000</td>
<td>360,000</td>
<td>36,000</td>
<td>35,968</td>
</tr>
<tr>
<td>450,000</td>
<td>3,507</td>
<td>10,862</td>
<td>181,000</td>
<td>269,000</td>
<td>30,507</td>
<td>30,508</td>
</tr>
<tr>
<td>300,000</td>
<td>9,357</td>
<td>5,012</td>
<td>84,000</td>
<td>216,000</td>
<td>27,357</td>
<td>27,328</td>
</tr>
<tr>
<td>150,000</td>
<td>14,368</td>
<td>Nil</td>
<td>Nil</td>
<td>150,000</td>
<td>23,368</td>
<td>23,368</td>
</tr>
<tr>
<td><strong>Single Female Age 63</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>300,000</td>
<td>9,357</td>
<td>5,012</td>
<td>96,000</td>
<td>204,000</td>
<td>27,357</td>
<td>26,608</td>
</tr>
<tr>
<td><strong>Couple: Male 65, Female 63</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>600,000</td>
<td>10,001</td>
<td>13,904</td>
<td>270,000</td>
<td>330,000</td>
<td>46,001</td>
<td>43,704</td>
</tr>
</tbody>
</table>
Taxation

A pension purchased within a superannuation fund would be exempt from tax.

Accordingly, a purchased Age Pension would also need to be tax free. However, this would add some complexity to the proposal. For those with a part Age Pension, they would have that part taxable under current legislation and the purchased balance tax free.

It is noted though, that little tax is actually paid on Age Pensions – perhaps a total of around $0.5 billion in the current year. Consideration could be given to making Age Pensions exempt from tax. This would achieve consistency with the treatment of private superannuation pensions, as well allowing payment of a full Age Pension made up of an eligible part and a purchased balance, to be wholly tax free.

Employment earnings

A resumption of paid employment after receiving a part Age Pension, or any change to employment earnings, would generate a revised means test assessment resulting in a change in the part Pension being received – or being stopped altogether.

Clearly, the simplicity of the proposal to allow purchase of the balance of the Age Pension, permitting the whole pension to be paid without further means tests cannot operate in such circumstances.

It would be necessary to exclude earnings from personal exertion from the means test when applying to purchase the balance of the Age Pension. This might be considered a good incentive to encourage such purchases!

It could be argued though, that eliminating employment earnings from the means tests for all Age Pensions would be a good policy generally. An estimate of the cost of this to the Government for the current year is around $1 billion. This compares with the Budget estimate for total Age Pensions currently, of $24 billion.

In practice, this measure would create an incentive to continue/resume working. The economic benefit from the likely increase in the work force participation rate could easily offset the relatively small cost of not assessing employment earnings for those in excess of Age Pension age.

For retirees already working in the “black economy” and “coming out of the woodwork” and disclosing their earnings, there would be no cost to Government from this measure!

Conclusion

Implementation of the proposal to allow self funded retirees to purchase the Age Pension could reduce significantly the number of retirees becoming Social Security Age Pensioners later in life. A variant of the proposal could also eliminate on going means tests and related administration for part Age Pensioners purchasing the balance of the Age Pension, as well as securing indexed lifetime income for them.

The proposal represents a reasonable option for a government, concerned about the financial consequences of the ageing population and keen to see more retirees effecting indexed lifetime pensions, but which does not wish to provide direct assistance to the life insurance and superannuation industries to encourage such pensions on a private basis.

Introduction of the proposal on an optimum basis may, however, require:

1. the exclusion of future employment earnings from the means test – either for the purchasers, or all part Age Pensioners;

2. the scrapping of future means testing for both any existing part pension and the purchased pension; and

3. the Age Pension to be made tax free.

Arguably though, such changes may well be considered to be worthwhile on their own merits, apart from simply improving the proposal to allow purchase of the Age Pension.

Postscript

Allowing purchase of the Age Pension would need to be supported by strong education initiatives to obtain widespread knowledge of the option.

At the same time, it would be desirable to see development of a “culture” to buy private lifetime annuities with part of superannuation proceeds. In this regard, the Government could assist this development by issuing longer term indexed bonds, and longevity bonds.

It would also be desirable to ensure that all future retirees are made aware of the opportunity to purchase lifetime annuities privately and/or the Age Pension from the Government. Super fund PDSs could be required to include reference to such retirement options. Applications for account based pensions or other withdrawals from the fund could include a section for acknowledging awareness of such options.

Undoubtedly, purchasers will tend to be those anticipating a long retirement – i.e. those in good health. However, if such purchases became widespread and part of retirement “culture”, it may become politically acceptable to make them the best option for most future retirees who wish to claim a part Age Pension.

Indeed, purchase of the balance of the Age Pension could be made a condition of the availability of a part Age Pension.

The alternative could simply be using up their own funds and then claiming the full Age Pension. This could be preferred by those in poor health.

Existing part Age Pensioners could be given the option of purchase of the balance, but would be able to remain on the current system of means testing if they wished.

Eventually though, means testing for Age Pensions after the initial assessment could cease to exist for all retirees.

Then, effectively, we would have a universal Age Pension – but only for those who need it or want it.
A SINGLE “UNABLE TO WORK” PENSION – TOWARDS ABOLISHING RETIREMENT

This option is explored in more detail in Darren Wickham’s 2007 paper “It’s time to abolish retirement (and here’s how to do it)”. Increasing lifespans and improving health at older ages mean that a fixed age social security retirement benefit does not make sense. As an ever increasing portion of over 65s are healthy and capable of work, it means (by default) a shift is occurring in the philosophy underpinning the Age Pension:

- moving away from targeting need (old age poverty arising as a result of disability or unemployment),
- to subsidising leisure (for over 65s who are healthy and capable of work).

As suggested in the abovementioned paper – disability and unemployment are arguably more suitable triggers than a fixed eligibility age for the receipt of benefits.

Proposal:
- The Age Pension, Disability Support Pension and Newstart (unemployment) Allowance are merged into a single “Unable to Work” pension.
- There is a single payment level for all recipients.
- Means tests could either be
  - Abolished (i.e. universal pension); or
  - Retained (but made the same for all categories of benefit).
- There is no “eligibility age” for a retirement benefit.
- There would be a long transition period (via a steadily increasing Age Pension eligibility age).

Advantages of proposal
- Fundamental shift in how society perceives old age;
- Increase in workforce participation;
- Social benefits for older people remaining in workforce;
- Improved work/life balance throughout entire life; and
- Transformation of superannuation into a lifetime savings vehicle instead of just for retirement. Assists transitions in workforce to and from learning, unemployment and disability.

NOTES
2. Launch of the discussion paper on Australia’s future tax system, 6 August 2008.
3. DFAC Trends in income and living standards of older people research paper # 6 (2000).
7. Based on ASIC Fido super calculator – $52 per annum fee + 0.55% asset fee, $78 per annum insurance premium.
8. Based on 10 guarantee period, 67% reversion to spouse – primary male annuitant being two years older than female spouse, ALT2000-02 with 105 year mortality improvement.
9. ABS 3222.0 “Population projections 2004-2101” (2006 Reissue) – “Series A” which the authors believe is the most realistic set of assumptions used by the ABS.
11. Assuming for those currently receiving a part Age Pension – the average assessed income is $9,187. This is consistent with the cost impact of cutting the taper rate from 50 per cent to 40 per cent shown in the “The Howard Governments Plan for a New Tax System” (1998).
12. Assuming the 20 per cent of part rate pensioners where the assets test is applying have full reduction of their pension by 3.9% x ($171,500 less $100,000). Further savings may occur for some recipients where the income test is currently applying instead of the assets test.
13. Assuming that of the approx 550,000 in the 65–69 Age group of Age Pension recipients around 55,000 would be exempted out of the pension due to not having used up their assets (i.e. approx 25 per cent of 65 and 66 year olds).
14. DFACS submission to 2002 Senate Inquiry into standards of living in retirement.
15. Clare, R “The interaction of the Age Pension and superannuation in the provision of Australian retirement incomes” (2007).
17. There are actually around 740,000 people of eligible age pension age. We have assumed that roughly 5% of these are not eligible due to residence requirements (in the 2006 census data, there were approx 30,000 new migrants over the age of 55 during the period 2002-2006) (table 3.1 3410D00018 Migrants, 2006 Census of Population and Housing, Australia).
18. FaHCSIA Portfolio Additional Estimates Statements for 2006-07, adjusted if applied in 06-07 year.
19. Service Pension, Service Pension partners, War Widows and Disability Pensions (not receiving a service pension). Note an approximation has been made for the age distribution of Disability Pensioners not receiving a Service Pension due to lack of data.
20. from Treasury’s 2007 tax expenditures statement.
21. Authors estimate based on pension assets of $300 billion (Rice Warner Actuaries), an average current tax rate of 9.0 per cent for accumulation assets and an average current tax rate of pension assets of – 4.0 per cent and an average before tax investment return of 8.0 per cent.
22. The 2007 IA Aust paper “Tax-free superannuation benefits: a future revenue problem?” forecast that superannuation investment tax revenue was to triple as a percentage of GDP between 2007 and 2040.