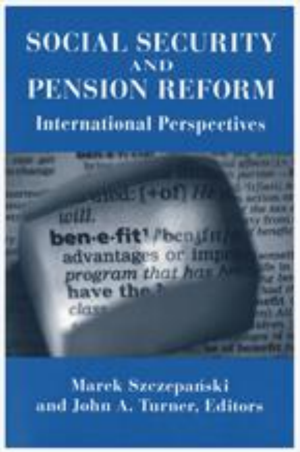
Australian Pensions: An Equitable Solution in a Postcrisis World?



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International Perspectives

Marek Szczepański
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Australian Pensions

An Equitable Solution in a Postcrisis World?

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PROVIDING SUPPORT FOR RETIREMENT IN AUSTRALIA

Australia has a classic three-pillar retirement system:

1) A mandatory contribution, generally to an individual account defined contribution plan, (made by employers) which is currently 9 percent of wages, increasing to 9.25 percent from July 2013 and then currently legislated to gradually increase to 12 percent by July 2019.
2) Voluntary contributions to pensions, primarily to defined contribution plans, many of which attract tax concessions.
3) A government means-tested pension, called the Age Pension, commencing at age 65 for males and (currently) 64 for females but increasing to age 67 over the next decade. Veterans (pensioners who have been in the armed services) receive identical benefits but receive them five years earlier than civilians. The Age Pension is not earnings related, It is paid at a higher rate to low-income persons due to the operation of a means test but is received by most retirees.

All elements have been subject to changes for fiscal and other reasons.

The voluntary contributions are from a number of sources:

- Employers (usually large companies and governments) that pay a higher rate than the law requires for mandatory pensions.

- Members paying pretax contributions from their salary package. The limit of tax-preferenced contributions has fallen significantly in recent years.
- Members paying after-tax contributions, which are subject to a contribution cap of $A150,000 a year or $A450,000 in a three-year period. (In early 2013, U.S.$1.00 = A $0.96. Currency conversion rates vary over time.)
- The government cocontribution, which matches after-tax contributions up to an amount which is currently A$500.00 a year for low-income earners.

The taxation structure for pensions is relatively complicated, but in broad terms most members of defined contribution funds are taxed concessionally (at a reduced and flat rate) in regard to contributions and investment earnings. Benefits, both lump sum and in income stream form, are tax free when received at age 60 and over. Thus, with *T* representing taxed, *t* representing concessionally taxed, and *E* representing exempt from tax, this system can be characterized as *ttE*. By comparison, the U.S. tax arrangement for most types of pensions is *EET*.

Despite the regular changes that governments have made for fiscal or equity reasons, the broad structure is robust and is supported by voters, politicians, and industry.

A critical element of Australia's retirement system, including the government mandated private pensions, is that members generally carry all the investment risks themselves because their pensions generally are defined contribution plans. While around 10 percent of employees are in defined benefit plans, most of these are closed to new members. In the long term, almost all members will have defined contribution pensions. However, there will be at least some defined benefit pensioners in the system for many decades to come.

Also important for the living standards of retirees are

- a high level of home ownership among retirees, and
- government funding on a means-tested basis of residential aged care and some other aged care.

The focus of this chapter is on mandatory and voluntary pensions and the means-tested Age Pension.

A BRIEF HISTORY OF SUPERANNUATION (PENSIONS) IN AUSTRALIA

Occupational superannuation in Australia first emerged in midnineteenth century. The term *superannuation* was in common usage in the early nineteenth century to refer to the pension received after retirement from the former employer. In most other countries, the term "private pensions" tends to be used to describe what is known as superannuation in Australia. While it is not entirely clear why the term superannuation is used in Australia, it does provide a clear distinction for private arrangements from the government-provided Age Pension. It also is more consistent with the availability of lump sum benefits from pensions in Australia, which are taken by a substantial number of retirees.

From its earliest days in Australia (with the establishment of a pension fund for its staff by the Bank of Australasia in October 1842) up to the 1940s, pensions were only available to a select, mostly male, group of salaried employees in the public sector and some large companies. Employer-supported pensions for wage staff tended to be less generous, with smaller benefits and smaller employer contributions in plans that were noncompulsory.

By 1974, 32.2 percent of wage and salary earners were covered by pensions, made up of 40.8 percent of male wage and salary earners but only 16.5 percent of females. Most pension assets were in defined benefit plans.

In 1983, the newly elected Labor Government expressed support for the principles of employee pensions and initiated discussions with the Australian Council of Trade Unions (ACTU) on the possibility of broadening access to pensions as part of the Government's Prices and Incomes Accord with the trade unions.

The process of making employee pensions a more or less universal entitlement began in September 1985 when, with the support of the government, the ACTU sought a 3 percent pensions contribution to be paid by employers to industry funds specified in relevant industrial labor agreements, which set the minimum wages and conditions for many but not all employees in Australia.

This submission was supported by arguments addressed to

- the implications arising from the trend towards an aging of the population including the workforce;
- the effects of the trend for earlier retirement;
- the existing dependency on Age Pensions and the projected significant increase in the dependency of the aged on the working population with an explosion of Age Pension costs; and
- the fact that a large percentage of the workforce was not covered by existing pension plans and that wide disparities existed in coverage according to sex, industry, occupation and income levels. In particular, it was submitted that women, manual workers and those in the lower income level were less adequately covered than others.

As new labor agreements were progressively negotiated according to the guidelines in the national wage case decision, pension coverage increased rapidly. In the four years after the introduction of employer contributions linked to labor agreements, employee coverage grew from around 40 percent to 79 percent. In the private sector, coverage grew from 32 percent in 1987 to 68 percent in 1991.

This was a major achievement for collectively bargained pensions, but more was needed in terms of coverage and rate of contributions. Accordingly, the government at the time announced in the 1991–1992 budget that it would introduce a mandatory pension system through the implementation of the Superannuation Guarantee. The Superannuation Guarantee pension system is based on using the taxation power of the Australian government to provide a very powerful incentive for employers to make pension contributions of the required amount. The guarantee part of the superannuation guarantee is about a requirement for contributions being made rather than a guarantee of investment earnings or eventual retirement income.

The Superannuation Guarantee system—the mandatory pension system—came into effect on July 1, 1992, starting at a minimum contribution level of 3 percent. A schedule of future increases in the rate of the Superannuation Guarantee contributions was also set, with a contribution rate for all employees of 9 percent of earnings. Employers already making contributions that met the requirements of the Superannuation Guarantee were not required to make additional contributions. Employees now generally are able to choose the fund to which they want to contribute, but many employees have contributions made to the fund that their employers have selected as the default fund or that is specified as a default fund in an industrial award. There are hundreds of corporate, retail, industry, and public sector funds and nearly 500,000 small Self-Managed Superannuation Funds.

While there has been growth in the number of self-managed superannuation funds, the numbers of the other types of funds have decreased over time. Self-managed superannuation funds are funds where each member is also a trustee of the fund. There is a general prohibition on membership of such funds by someone who is an employee of another member of the fund. The result is that a small business owner cannot include his or her employees in the self-managed superannuation fund of which the business owner is a member. They have less than five members each, and they differ from the various individually managed accounts in other countries in that they are a private trust arrangement that does not require a financial institution to be involved as a provider.

The coverage of the system was very broad, using wide definitions for employer and employee. However, there were some exceptions, chiefly those earning less than A$450 per calendar month, part-time employees aged under 18, and those over 65. As well, the Superannuation Guarantee does not apply to the self-employed (other than to owner-managers who receive wages and technically are employees of a company they control). Around 30 percent of the self-employed make voluntary contributions, partly driven by the tax concessions available for this. Some self-employed persons will have a private pension because of previous periods when they have been an employee. Some contractors who might be regarded as self-employed by other legal provisions are also covered in the compulsory system through an extended definition of employee.

In May 2010, the Australian Treasurer announced that compulsory employer pension contributions were to increase to 12 percent by July 2019. The increase in mandatory Superannuation Guarantee contributions is a gradual process, starting with 0.25 percent in the 2013–2014 financial year, and then a 0.25 percent increase in 2014–2015. For the following five years after the 2015 financial year, the Superannuation Guarantee rate will increase by 0.5 percent until it reaches 12 percent by July 2019. A new government was elected in September 2013 and as part of its election policies indicated an intention to legislate a two year pause in the phased increase in the rate of contributions.

THE AGE PENSION NOW AND INTO THE FUTURE

The Age Pension—the means-tested pension—is funded out of general tax revenue by the Australian government. It does not require either a history of social security contributions by the person or a history of work; rather, receipt is determined by reaching the eligibility age, being a resident in Australia for 20 years, and qualifying under the applicable asset and income tests. The maximum benefit provided by the Age Pension as of September 1, 2012, is A$20,142 for a single person and A$30,368 for a couple. The Age Pension is taxable, but due to a variety of rebates, those receiving the maximum benefit generally do not pay any income tax. People with higher income and assets in retirement receive a reduced Age Pension. Many people receive a partial Age Pension, but persons at the top of the income distribution do not receive any benefit from the Age Pension.

Table 9.1 shows budget standards for a modest and comfortable lifestyle as indicated by the Association of Superannuation Funds of Australia (ASFA) retirement standard. These budget standards are based on a typical retiree at age 65 and are widely used in Australia as an indicator of adequacy of retirement income. They are updated regularly on the ASFA Web site (www.superannuation.asn.au). ASFA is a private-sector, not-for-profit organization whose members are pension funds and service providers to pension funds.

While these values do not reflect the situation of every retiree, they allow us to gauge the average needs for different lifestyle expectations given cost of living in Australia as of December 2012. These are compared with the maximum annual benefit of the Age Pension as of September 2012.

It is clear that the Age Pension is close to meeting the modest lifestyle needs of retirees. As the benefit is linked to national average wages and the modest lifestyle is linked to prices, the Age Pension will gradually close in on the modest lifestyle for at least a period of some years.

Table 9.1 The Age Pension Compared to the ASFA Retirement Standards

	Modest lifestyle single	Modest lifestyle couple	Comfortable lifestyle single	Comfortable lifestyle couple
Yearly total ($)	22,585	32,555	41,186	56,339
Age Pension ($)	20,142	30,368	20,142	30,368
Difference from Age Pension ($)	2,443	2,187	21,044	25,971

NOTE: All values in Australian dollars.
SOURCE: ASFA (2013).

The ASFA retirement standard is adjusted for changes in prices every quarter, but every four or five years it is adjusted more substantively for changes in the pattern of expenditure by retirees and for increases in the general living standard of the community. For a comfortable lifestyle, retirees need to build their own pension savings, as the Age Pension by itself will be inadequate.

THE FISCAL SUSTAINABILITY OF THE AGE PENSION

Australia is unusual in that the future financial impact of programs such as the Age Pension is required to be assessed on a regular basis in what is known as the Intergenerational Report (IGR) which is prepared by the Australian Treasury. The IGR came to life as a key requirement of the 1998 Charter of Budget Honesty Act. The charter requires an intergenerational report to assess the long-term sustainability of policies over the 40 years following the release of the report, including the impacts of demographic change. The IGR has played a major role in raising community awareness of long-term fiscal challenges and, in so doing, placed greater focus on government decisions with long-term consequences.

For instance, in the fiscal year 2009–2010 budget, the government announced increases to Age Pension benefits, particularly for single persons, following an inquiry process that indicated the desirability of increasing such payments. These increases were introduced along with a suite of budget-saving measures designed to offset their long-term costs. The budget-saving measures included a gradual rise in the qualifying age for the Age Pension (to be phased in from 2017 to 2023), means testing of the private health insurance rebate, as well as reforms to family payments and pensions. The package of changes was projected to be budget neutral by 2021–2022 and through to 2049–2050 as a result of the effect of the expenditure saving measures offsetting the increase in the costs of he Age Pension.

Australia was relatively unusual in the international community in that it weathered the global financial crisis without significant impacts on economic activity, unemployment, or fiscal outcomes. While the current budgetary situation is not without challenges, with the then government recently formally announcing that a target of a budget surplus in 2012–2013 would not be met, the budgetary situation has been sufficiently robust to support both the increase in the Age Pension benefits and the increased tax expenditures associated with higher compulsory contributions to pensions. In regard to the latter, there was an explicit linking of the introduction of a new resources rent tax associated with certain mining activities with the legislation increasing the Superannuation Guarantee contribution rate. The legislation increasing the Superannuation Guarantee contribution reduced income tax receipts due to the reduction in net wages, which is only partially offset by the tax on contributions, while the resources rent tax provided an offsetting increase in taxes. As noted earlier, the government elected in September 2013 proposes a two-year pause to the increase in the rate of compulsory contributions.

However, over a longer time period, aging of the population will still contribute to pressure on government spending and fiscal sustainability. The Intergenerational Report (IGR) prepared by the Australian Treasury projects total spending to increase to 27.1 percent of GDP in 2049–2050, around 4.75 percentage points higher than its projected low point in 2015–2016. In today's terms, that is the equivalent of adding around $A60 billion a year to government spending.

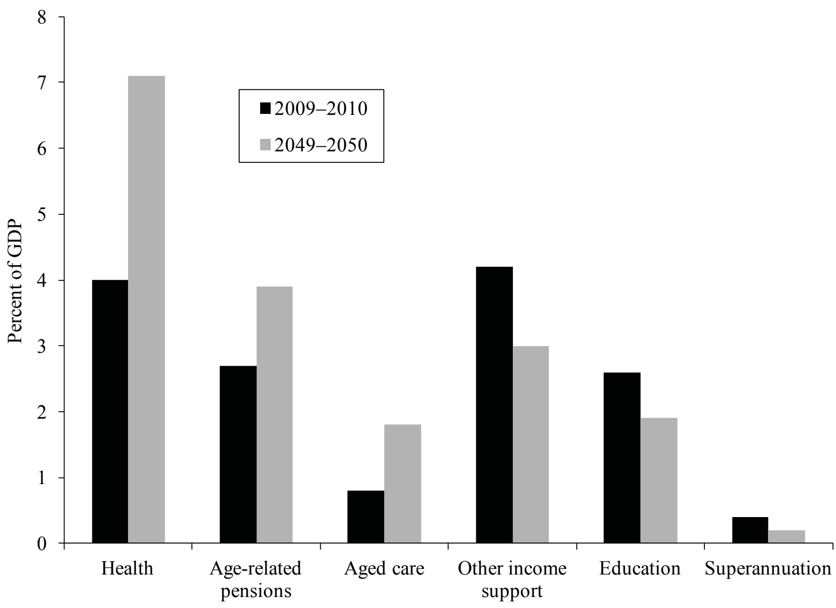
Around two-thirds of the projected increase in spending over the next 40 years is related to health, reflecting pressures from aging, increased community expectations, and the funding of new technologies. Growth in spending on age-related pensions and aged care is also significant, both as a proportion of GDP and in real spending per person. Currently, about a quarter of Australian government spending is on health, age-related pensions, and aged care. The Intergenerational Report projects that Australian government spending on these functions will increase significantly over the next 40 years, pushing their share of spending to almost one-half.

As a proportion of GDP, spending on health is projected to rise from 4.0 percent to 7.1 percent. Age-related pensions and aged care are projected to rise from 2.7 percent and 0.8 percent of GDP to 3.9 percent and 1.8 percent, respectively, in 2049–2050. Figure 9.1 provides further details by each major expenditure category.

Excluding public debt interest, the Intergenerational Report projects a fiscal gap of 2.75 percent of GDP (or around $A30 billion in today's dollars) by 2049–2050.

Much of the increase in government expenditure on Age Pensions is due to population aging. Unlike some countries, such as Japan, the Australian population will continue to grow, as annual rates of population

Figure 9.1 Projected Expenditure by Major Category



SOURCE: Australian Treasury (2010).

growth are projected to slow gradually, from 2.1 percent in 2008–2009 to 0.9 percent in 2049–2050. Australia's population is projected to grow from around 22 million people to 35.9 million people in 2050.

As well, average Australian mortality rates have fallen significantly, with life expectancies rising for both men and women. These changes have added to population growth and the proportion of older people in the Australian population. As a result, the number of Australians aged 65 and over is projected to grow from around 3 million in 2010 to 8.1 million by 2050, from 2.1 percent of the population to 5.1 percent. As a result, the number of people of eligible age for the Age Pension is projected to increase by around 150 percent by 2049–2050.

There are other factors that affect the projections of age-related pension spending:

- A decline in the proportion of pensioners receiving a full Age Pension, because of the increased value of individuals' mandatory pension and other private assets and income.
- The proportion of people with a partial Age Pension is projected to increase significantly while the proportion of the eligible age group not receiving any Age Pension is projected to rise slightly.
- As noted earlier, the increase in the level of the Age Pension benefits has been largely offset by other policy measures, such as raising the eligibility age.

When the next Intergenerational Report is prepared in or before 2015, it can be expected to take into account the phased increase in compulsory pension contributions from 9 percent to 12 percent. This will further moderate the increase in age-related pension spending, particularly toward the end of the projection period.

Of course, there are consequences flowing from compulsory pension contributions for the public sector's contribution to private (and therefore national) saving as a result of the compulsory pension system. This public sector contribution arises from the tax-preferred status of compulsory pension contributions and the assumption by the Australian Treasury that other expenditures are cut back to allow for this tax expenditure. The public sector's contribution is estimated to be about 0.4 percent of GDP currently, rising gradually to nearly 0.7 percent of GDP by the end of the decade, and then staying around that level to the middle of the century.

The estimated net fiscal cost to the government budget is smaller than the public sector's contribution to private saving, because budget savings arising from the compulsory pension system reduce the net fiscal cost of compulsory pensions. This is because growth in net wages is less than it would otherwise be because of the increase in pension contributions, leading to increases in expenditure on Age Pension and other government payments indexed to movements in average net wages being less than they would otherwise be.

Equity clearly is a key issue in the debate about pension and retirement income reform. There is strong government and community concern that the assistance provided to retirement income should be spread fairly according to need. There also is a strong tradition in Australia of support for what we colloquially call a "fair go." In the context of pensions, this means that no groups should face barriers to participation in the retirement income system.

One statistic that gained some currency in public debate in Australia was that 5 percent of individuals account for 37 percent of tax-preferenced pension contributions. However, that is no longer the case and is now something of an urban myth—that figure, calculated by the Treasury, related to 2005–2006, when pension policy settings were significantly different than they are now. For instance, in 2005–2006, a maximum deductible contribution limit of $A100,587 applied for each employee aged 50 and over and for the self-employed aged 50 and over. For those aged 35–49 the figure was $A40,560 a year.

By fiscal year 2009–2010, a new set of tax-preferenced contribution caps was in force (after a number of variants along the way). These caps permitted annual contributions of no more than $A25,000 a year for those under age 50 and $A50,000 a year for those aged 50 and over. However, the $A50,000 a year cap was a transitional one and expired on June 30, 2012. The government has announced its intention to replace these caps with a general cap of $A25,000 a year except for those aged 50 and over with less than $A500,000 in pension savings, where a $A50,000 a year cap would apply. However, the introduction of this higher cap for those aged 50 and over has been delayed due to budgetary reasons.

Tax-preferenced contributions include employer contributions (including contributions made under a salary sacrifice arrangement where wages are traded for extra contributions), and personal contributions claimed as a tax deduction by a self-employed person.

Tax Assistance for Pensions after the New Tax-Preferenced Contribution Caps

Clear empirical evidence indicates that the contribution caps have reduced the tax-preferenced pension contributions made by upper-income earners. This is reflected in Table 9.2, which sets out estimates of the proportion of tax-preferenced pension contributions made on behalf of wage earners in the various marginal income tax bands applying in 2009–2010. These estimates are based on data especially extracted for ASFA from a large scale survey of Australian households, namely the Household, Income and Labour Dynamics in Australia (HILDA) Survey.

These estimates of employer contributions are consistent in broad terms and produce overall results consistent with aggregate pension contributions as reported by the Australian Prudential Regulatory Authority (APRA), which is one of the government regulators of the financial services industry (including pensions), and Australian Taxation Office statistical publications.

As is clear from the table, pension contributions are not spread entirely evenly across all taxpayers or income ranges. This is because one of the basic characteristics of pensions is that contributions are linked to employment, particularly full-time employment. Those taxpayers on very low incomes are not receiving pension contributions made by their employers or are receiving the benefit of only relatively small contribution amounts.

Individuals on a low income in any given year will not necessarily be on a low taxable income for all of their lives. Many individuals who have low taxable incomes from employment are undertaking part-time employment when they are studying or when they also have family responsibilities that prevent them from undertaking full-time work. However, over their lifetime they will have many years, usually decades, of full-time work. As well, wages often increase in real terms over the course of a career. The distribution of taxable incomes and tax concessions for pension contributions in any given year is not a good indicator of assistance delivered over a lifetime.

Table 9.2 Employer Contributions by Income Range, 2009–2010

Taxable income range ($A)	Marginal income tax rate (%)	% of wage earners	Value of employer contributions[a] $A million	% of employer contributions[a]
0–6,000	0	5.4	54	0.1
6,001–37,000	15	31.5	4,255	7.9
37,001–80,000	30	42.7	23,120	43.0
80,001–180,000	38	18.0	20,280	37.7
180,001+	47	2.4	6,050	11.3

[a] Based on data extracted for ASFA from Wave 10 of the HILDA survey.
SOURCE: Clare (2012a).

However, even in regard to a single year, as indicated by Table 9.2, around 90 percent of employer contributions relate to individuals on less than the top marginal tax rate, with over 50 percent of contributions relating to individuals on a marginal income tax rate of 30 percent or less.

The top 5 percent of employees (in terms of income) accounted for less than 20 percent of the total pension contributions in 2009–2010.

While upper-income earners typically have more pension contributions than lower-income earners, the amount related to upper income earners is now much lower than it was previously. While a higher figure may have applied back in 2005–2006, the impact of the contribution caps has been considerable. The various changes that have been made to the pension tax rules also may have affected confidence in contributing to pensions also leading to lower discretionary contributions.

Table 9.3 provides estimates of the amount of tax concession by personal income tax rate. It also factors in the receipt of the cocontribution (government matching contribution), which is only available to low-income earners making personal contributions.

Table 9.3 indicates that in recent times less than 15 percent of the government assistance for pension contributions flows to those on the top marginal rate. This compares to the around 30 percent of aggregate personal income tax collections that is paid by that group of taxpayers. While upper-income earners do receive assistance for their pension contributions, the overall personal tax system imposes a substantially higher tax burden on upper-income earners compared to those earning

Table 9.3 Employee Tax Concessions by Income Range, 2009–2010

Taxable income range ($A)	Marginal income tax rate (%)	Value of tax concession[a] $A, millions	% of total tax concession for employer contributions	Value of tax concession and cocontribution $A, millions	% of total tax concession and cocontribution[b]
0–6,000	0	−8	−0.1	192	1.5
6,001–37,000	15	68	0.6	1,068	8.3
37,001–80,000	30	4,462	39.2	4,662	36.4
80,001–180,000	38	4,968	43.6	4,968	38.8
180,001+	47	1,906	16.7	1,905	14.9
All employees		11,396	100.0	12,795	100.0

[a] Takes into account the Medicare levy, the phasing out of the Low Income Tax Offset, and the phasing in of the Medicare liability.
[b] Column does not sum to 100 because of rounding.
SOURCE: Clare (2012a).

lower incomes. It could be argued that the general tax and transfer system in Australia should and does do most of the "heavy lifting" in terms of improving vertical equity.

Table 9.3 also indicates that the bulk of government assistance for pensions flows to those on either the 30 percent or 38 percent tax rates. Such taxpayers make up a very large part of the full-time workforce in Australia. Providing the bulk of tax assistance to this group makes sense from a public policy point of view. In contrast to very low-income earners and those who never have significant wage incomes during their lives, they have the potential to finance through savings significant income in retirement.

For those on the top marginal tax rate, achievement of significant savings in the form of pension savings has the potential to make them totally self-funded in retirement, with no reliance on the government-provided Age Pension.

The Australian government has also legislated to provide a new matching contribution of up to $A500 annually for eligible low-income earners from the 2012–2013 income year. The payment will be 15 percent of the eligible tax-preferenced contributions (including employer contributions) made by or for individuals with adjusted taxable incomes of up to $A37,000. Individuals will also need to meet a test where at least 10 percent of their incomes must be from employment or business sources and they are a resident of Australia or New Zealand. Individuals also can benefit from the cocontribution in regard to personal contributions that are not tax-preferenced.

By its very nature, new matching contributions will only provide assistance to low-income earners on either the 0 or 15 percent tax rate. However, the government elected in September 2013 has indicated its intention to abolish this government contribution for low income earners.

As well, the phased increase in the rate of compulsory contributions to 12 percent will have its greatest impact on low- and middle-income earners, given that those earning higher incomes commonly already receive the benefit of contributions in excess of 9 percent of wages and/or will adjust voluntary salary sacrifice contributions if there is an increase in compulsory contributions.

Table 9.4 compares the distribution of government tax relief and contribution assistance for pensions in 2009–2010 for employees on

Table 9.4 Current and Proposed Government Assistance for Pension Contributions by Income Range

Taxable income range ($A)	Marginal income tax rate (%)	Current value of tax concession and cocontribution[a] ($A, millions)	% of current total tax concession and cocontribution[b]	Value of proposed total tax concession and government contributions[a] ($A, millions)	% of proposed total tax concession and government contributions
0—6,000	0	192	1.5	210	1.4
6,001–37,000	15	1,068	8.3	1,640	11.0
37,001–80,000	30	4,662	36.4	5,732	38.3
80,001–180,000	38	4,968	38.8	5,465	36.6
180,001+	47	1,905	14.9	1,905	12.7
All employees		12,795	100.0	14,952	100.0

[a]Takes into account the Medicare levy, the phasing out of the Low Income Tax Offset, and the phasing in of the Medicare liability. Based on 2009–2010 tax rates.

[b]Column does not sum to 100 because of rounding.

SOURCE: Clare (2012b).

the basis of current policy settings and what it would have been if a 12 percent mandatory contribution rate, the low income matching contribution payment and the current rate of cocontribution had all applied in that year. While it will be some years before all the measures are fully in place this approach illustrates what the eventual impact on the distribution of government assistance by income level will be.

The combined effect of the government proposed measures would have, if they had applied in 2009–2010, increased the total assistance for retirement saving for employees earning less than $A80,000 a year from $A5,920 million to around $A7,580 million. Expressed as a percentage of total government assistance, the share of those earning less than $A80,000 a year would have increased from 46.2 percent to 50.2 percent. Clearly, the measures strongly favor those on lower incomes.

GOVERNMENT ASSISTANCE FOR BOTH MANDATORY PENSIONS AND THE AGE PENSION

There is also a direct link between the level of retirement savings and the subsequent reduction in the government Age Pension. In considering the equity of government assistance for retirement income, it also is necessary to take into account the amount of the Age Pension that will eventually be provided on average to persons on various levels of earnings and pension contributions during their working life.

This was done in research conducted in 2009 by George Rothman of the Australian Treasury Retirement & Intergenerational Modelling & Analysis Unit. This research places emphasis on a "whole of life" or life cycle perspective where Age Pension benefits in the retirement phase are included. The cost to government of its retirement income policies as a whole is modelled using the Treasury's comprehensive RIMGROUP model.

The base case for this analysis is the retirement income framework following the 2009 government budget. Significant changes in that budget included

- a significant increase in Age Pension payments of $A32.49 a week for single pensioners and $A10.14 a week combined for couple pensioners, together with changes to the income test, whereby the pension taper rate for new pensioners, which reduces the Age Pension for persons receiving higher levels of income, is 50 percent rather than 40 percent;

- a gradual increase in the age for eligibility for an Age Pension beginning in 2017 so that this age reaches 67 in 2023; and
- a reduction in the annual cap on tax-preferenced pension contributions from $A50,000 to $A25,000 for those younger than 50 and the transitional cap for those in their 50s from $A100,000 to $A50,000. This limit applies to the combined compulsory and salary sacrifice contributions. Individuals generally will not exceed this limit as the result of compulsory contributions alone given there is a cap on compulsory contributions per job that is below the tax-preferenced cap.

The analysis in the Treasury paper indicates that these measures have added considerably to the equity of Australia's retirement income system, both by gender and income. The tax-preferenced contribution caps budget measure also was found to add even more vertical equity to the system with the saving to government revenue impacting mostly on the top two deciles of the income distribution for both men and women.

Table 9.5 Net Present Value of Cost to Government of Retirement Income System by Income Level ($A, millions)

Decile	NPV1-women	NPV1-men	NPV1-both
1	1,750	1,600	3,350
2	1,700	1,600	3,350
3	1,650	1,600	3,300
4	1,650	1,600	3,300
5	1,650	1,600	3,200
6	1,650	1,750	3,400
7	1,900	1,800	3,700
8	1,850	1,950	3,800
9	1,850	2,050	3,950
10	1,800	2,450	4,250
All	17,500	18,050	35,550

NOTE: Columns do not precisely add up to the totals because of rounding.
SOURCE: Clare (2012b).

The research also indicates that the total amount of government support does not vary much across the income deciles or by gender. Table 9.5 sets out the Treasury forecasts of government assistance for those born in 1960 and retiring in 2027. The proportion of assistance provided in the form of tax expenditures on pensions increases with higher income with a more or less equivalent decrease in the value of Age Pension expenditures.

Overall government support for the Age Pension was found to account for 82 percent of the government assistance to women for their retirement and 68 percent of the assistance provided to men.

One group that receives above average assistance is men in the top income decile. For the other income deciles, the withdrawal of the Age Pension largely matches the assistance given to higher pension contributions. However, this became irrelevant for those who are not entitled to even a partial Age Pension. Limiting the tax-preferenced contribution cap to $A25,000 a year for those aged 50 and over with more than $A500,000 in pension is a policy response to this distributional finding.

THE REAL EQUITY CHALLENGE

The real issue in regard to equity is that too many Australians have too little in retirement savings rather than too much. While much public debate has focused on the top 1 percent or 5 percent of income earners, there has been little or no debate on how to advance outcomes for the other 99 percent or 95 percent.

If excessive government assistance is a problem, it is restricted to a very small number of individuals. This is particularly the case since the introduction of progressively tighter caps on both tax-preferenced and non-tax-preferenced contributions. When properly measured, the total government assistance for retirement income in the form of both the Age Pension and tax concessions for pensions is broadly even across the entire income distribution.

After the recent contribution cap and rebate changes to private pensions, 87.3 percent of the tax concessions for pensions will flow to individuals on less than the top marginal tax rate, up from the around 85 percent, which applied before the changes. The share of total concessions flowing to individuals on the top marginal tax rate was around 50 percent in 2007–2008, with the reduction in the share since then due to the introduction of contribution caps and higher rates of tax on the contributions of certain upper-income earners, together with the top marginal rate applying to a smaller proportion of taxpayers.

ASSISTING THOSE WHO REALLY NEED ASSISTANCE

Evidence from surveys of pension account balances held by individuals indicates that compulsory pensions have been very effective in lifting coverage rates and average pension account balances (Table 9.6).

The increase in the mandatory Superannuation Guarantee contribution rate to 12 percent will further improve pension balances at retirement, but it will be 40 or 50 years before the system is fully mature, meaning that all workers will be under that regime for their full careers.

However, voluntary contributions have remained flat in recent years in response to both tax changes and investment return developments. In particular, contribution caps and other changes to pensions are limiting the amount of voluntary salary sacrifice contributions, including by individuals seeking to catch up on contributions late in their careers. Salary sacrifice contributions are made when an individual trades part of his salary for additional employer contributions.

Longitudinal data indicate that a significant proportion of the population have higher incomes (with associated capacity to make higher contributions) for a relatively limited portion of their working careers. A higher contribution cap generally, or at least for those aged 50 and over, would assist those who need to catch up and have a capacity to do so.

While the pension cocontribution (matching contribution) made by the government has been effective in lifting personal contributions of low-income individuals, the design parameters of the cocontribution and recent cutbacks to them have made the cocontribution less effective than it could be. There is a case for both a higher maximum cocontribution and a lower matching rate in order to encourage greater additional contributions.

Table 9.6 Pension Coverage and Pension Holdings of Men And Women Who Were Not Yet Retired, by Annual Salary Income, 2006 and 2010

	2006			2010		
		Pension balance of those with super ($)			Pension balance of those with super ($)	
Annual wage and salary income ($)	% with pension	Mean	Median	% with pension	Mean	Median
Men						
< 28,000	75.1	37,312	5,700	79.9	43,553	5,000
28,000 – < 58,000	96.7	70,698	30,000	96.8	62,853	25,000
58,000 – < 80,000	98.1	134,981	65,000	98.7	108,092	50,000
80,000+	97.8	207,801	110,000	98.6	212,025	110,000
Total	91.4	99,506	35,000	93.9	109,609	40,000
Women						
< 28,000	80.7	32,807	9,000	80.9	37,622	8,500
28,000 – < 58,000	96.8	56,253	25,000	96.6	52,885	29,000
58,000 – < 80,000	98.6	102,844	55,000	98.2	98,071	50,000
80,000+	97.7	158,652	88,000	98.9	142,855	75,000
Total	89.4	55,433	21,000	90.9	63,412	26,000

NOTE: Population weighted results.
SOURCE: HILDA data.

The $A450 a Month Threshold for the Superannuation Guarantee Mandatory Contributions

While there may have been a rationale for the income threshold below which contributions are not required when the mandatory Superannuation Guarantee pension system was first introduced, it would make sense to remove it now given that nearly all employees have a pension account, and processes for making contributions are now more efficient. Around 250,000 individuals, the majority of whom are women, would benefit from removal of the threshold through higher eventual retirement savings. The cost to both employers and to the Australian budget from removing the threshold would be very modest.

The Self-Employed

Nearly 10 percent of the labor force are self-employed. While tax concessions have led to some self-employed persons saving for retirement through pensions, average balances and coverage have remained relatively low. Around 29 percent of the self-employed have no pension savings (this is more common for males than females). There is a strong case to extend compulsory pensions to include the self-employed.

Individuals on Paid Parental Leave

Paid parental leave is considered by the government to be equivalent to wages in terms of income tax and other treatment of individuals. Consistent with this, it would be appropriate for the Superannuation Guarantee mandatory pension contributions to apply to such payments, which it does not currently do.

One of the reasons that the average pension balance of women is lower than that of men is time out of the paid workforce for parental reasons. Paying Superannuation Guarantee mandatory contributions on parental leave payments would help reduce this difference in entitlements. The effects of compound interest also would be very favorable in regard to pension contributions made on behalf of women who take parental leave, mostly in their 20s and 30s. The cost to the Australian government budget would be just over $A20 million a year.

Indigenous Australians

Indigenous Australians have lower coverage and lower balances on average than the general population, again largely related to differences in paid labor force experience. Pension coverage for indigenous Australians is about 70 percent for men and 60 percent for women, compared to rates of 85 percent for men and 80 percent for women for the population more generally. Average (mean) balances are also lower than for the equivalent Australian population as a whole (Table 9.7).

Increases in the pension coverage and average pension balances of indigenous Australians will clearly be associated with improvements in involvement in paid work and in wages. Labor market measures rather than pension policies drive labor market outcomes.

However, current pension arrangements and administrative requirements do not always mesh well with the circumstances and needs of indigenous Australians, particularly those in remote areas who may have difficulty communicating with their pension fund administrators and in claiming benefits or identifying lost accounts.

There is scope for the pension industry and the regulators to work toward a regulatory framework and administrative arrangements that can better cope with the special needs of indigenous Australians. Such arrangements also would be likely to benefit many other Australians.

Table 9.7 Pension Coverage And Pension Holdings of Aboriginal and Torres Strait Islander Men and Women Who Were Not Yet Retired, 2006 and 2010

	2006			2010		
	% with pension	Pension balance of those with super ($A)		% with pension	Pension balance of those with super ($A)	
		Mean	Median		Mean	Median
Men	68.3	49,589	9,000	70.7	55,743	14,000
Women	52.1	42,109	10,000	60.6	39,909	15,000
Persons	59.5	46,069	10,000	65.3	47,863	15,000

NOTE: Population weighted results. Not enough cases to break down by age.
SOURCE: Clare (2012b).

Recently Divorced Men and Women

Survey data indicate that the distribution of pensions is now much more even for those who have recently divorced compared to when amendments were made in 2002 to the Family Law Act to allow the splitting of pension account balances. The extent of disparities in particular decreased between 2006 and 2010. While a number of factors would have contributed to this, the growing maturity of the compulsory pension system leading to higher average account balances for both men and women would have played a role, along with more women having pensions in their own right. The figures also are consistent with the parties in a marriage making more use of the splitting arrangements.

Exposure to Investment Risk

Currently in Australia, around 90 percent of individuals in the preretirement phase who have a pension, and around 75 percent of those recently retired with a pension, are exposed to investment risk. The proportion is higher in the preretirement phase given that the newer and younger fund members have been predominantly enrolled in defined contribution arrangements.

As shown in Table 9.8, investment returns in Australia, as in many other countries, have not been favorable in recent years. The global financial crisis had a significant impact, particularly given the 65–70 percent exposure on average of most funds to equities.

Investment returns in 2012–2013 were relatively high, with preliminary estimates indicating an average rate of return for default members of funds of over 15 percent.

The rationale for relatively high levels of exposure to equities in defined contribution plans (accumulation funds) is that this will generally lead to higher retirement benefits for members. Most individuals will be a member of a pension fund for a period of 40 years or more. Subject of course to individual decisions regarding exposure to investment risk and volatility, there is an argument that such exposure should be sustained throughout a member's career.

However, market volatility means that at least some members will wish to shift assets into cash over the five years before retirement. This will allow them to cater for any required lump sum benefit and their

Table 9.8 Average Annual Fund Investment Returns to June 30, 2012

Year	Real returns (%)
1	0.3
5	−0.7
10	5.2
15	5.5
20	7.0
25	7.2
30	10.0
35	10.8
40	9.9
50	9.9

SOURCE: Annual survey published by ASFA.

initial pension drawdowns. Life cycle investment options can provide such an investment strategy. However, while they are suitable for some individuals, they may not be suitable for others.

Historical analysis also indicates that a typical life cycle fund would have delivered poorer outcomes for most members over most periods in Australia, such as 1900–1970, 1970–1999, and 1900–1999. Now is also not a good time to switch allocations from equities to bonds as returns to bonds are at historical lows and recent returns from equities, especially Australian equities, have been relatively strong, with double-digit returns in calendar 2012, particularly the second half of 2012.

While consumer satisfaction with pensions tends to follow with a lag in developments in investment returns, there has been little pressure in Australia for the government to cover any investment losses faced by fund members due to general developments in investment markets. The only policy response to the global financial crisis was to reduce the minimum drawdown factor for individuals who have an individual account–based (defined contribution) income stream in retirement. There are compensation arrangements that can be called upon in the case of members suffering loss due to fraud or theft in a regulated fund, but fortunately fraud or theft are relatively rare in the regulated pension funds. Compensation in these cases is effectively funded by members of other regulated pension funds through special levies struck by the government in such cases.

INCOME STREAMS IN RETIREMENT

In an ideal world, the objective of pensions should be focused on the provision of income during the whole of retirement. However, there are a number of reasons why it is difficult to structure the Australian system around regular reliable pension payments. These include the following:

- When pension contributions began to be included in labor agreements in 1986 as deferred pay (in lieu of a possible productivity wage rise), it was promoted to members as an addition to the Age Pension. The Superannuation Guarantee pension has increased the value of contributions, but the message has not changed—members consider that the private pension account balance is their own money and they expect flexibility of payments.
- The government allows all members above age 60 to retire and draw a tax-free lump sum or pension. Most older Australians also are subject to low or nil rates of personal income tax given low average incomes and various tax rebates. As a result, there is only a limited incentive for individuals to leave money in the system during retirement.
- There are no longer maximum withdrawal factors on account-based defined contribution pensions, so nobody is forced to draw their benefits over time.
- Members can buy lifetime annuities from the private sector (albeit from a small number of suppliers), but current sales are well under 100 a year in total. Consumer research indicates that most Australians are unrealistic about the pricing of an indexed lifetime annuity and expect much more than fair value. Without compulsion or incentives, most members will not buy these products.
- Many members retire with small benefits, and they appear comfortable with leaving the money in an interest-bearing bank account rather than in a pension. This may be influenced by their perception of safety in the bank or by a short time horizon where they do not value higher (but uncertain) returns. They may also value instant access to their funds.

- Many people today retire with some debt (including mortgages) or the need to carry out home repairs or consumer durable purchases, and it is a rational decision to take a pension lump sum to clear all such expenses or debts before retiring.
- Around a third of total pension savings and around half of post-retirement pension balances are held in Self-Managed Superannuation Funds, which have less than five members and where each member is also a trustee of the fund. Such fund members generally value control highly and are wary of purchasing an income stream from a third party such as a life insurance company or managed fund.

The above situation has made the provision of income streams, particularly those that protect members from their longevity risk, difficult. In addition, transitional arrangements, especially if compulsion is involved, can be problematic due to the plans made by those approaching retirement.

That said, the evidence available indicates that many Australians do take an income stream from their pension in retirement, albeit one that is account based, where the individual can access the entire account balance should they choose to do so. This is particularly the case when larger amounts are involved.

As shown in Table 9.9, around 70 percent of males aged 60–64 who have recently retired have a pension with an average balance of around $A380,000. This is a drop in coverage of around 20 percentage points compared to those who are in the same age group who have not retired. The average balance is also higher than for those not retired, which suggests that those with lower balances are more likely to cash out and invest (or spend) elsewhere.

For women, the drop in coverage is greater, at around 30 percentage points. Again, the average balances for those retaining retirement savings in a pension, at around $A255,000, is higher than for those in the same age group who have not retired.

These figures strongly suggest that the great bulk of recent retirees keep their retirement savings primarily in a pension account and draw down an income stream. Those retirees who take their retirement savings out of the pension system are a minority. However, even for this minority there is no evidence that the pension savings are used pri-

Table 9.9 Pension Coverage and Pension Holdings of Men and Women Who Were Recently Retired, 2006 and 2010

	2006			2010		
		Pension balance of those with super ($A)			Pension balance of those with super ($A)	
Age group	% with pension	Mean	Median	% with pension	Mean	Median
Men						
<60	70.2	283,430	200,000	89.8	528,105	386,000
60–64	76.7	573,228	500,000	68.8	381,703	250,000
65–69	48.1	421,618	200,000	65.7	299,161	164,000
70+	41.6	283,938[a]	162,000[a]	32.3	273,218[a]	90,000[a]
Total	60.7	419,841	280,000	60.8	367,336	245,000
Women						
<60	62.1	322,945	100,000	63.7	135,501	53,000
60–64	53.1	273,135	195,000	58.6	255,485	120,000
65–69	46.4	129,491	90,000	41.7	205,855	70,000
70+	41.6[a]	48,358[a]	15,000[a]	7.1[a]	184,000[a]	184,000[a]
Total	54.5	254,647	100,000	53.0	191,474	102,000

[a]Estimate not reliable.

NOTE: Population weighted results. "Recently retired" if "currently retired and observed not retired (i.e., employed) at some stage in the last three years."

SOURCE: HILDA data.

marily for immediate consumption purposes, such as an overseas trip. While some commentators claim that that frequently happens, such assertions are more in the line of urban myths than being supported by any objective research. However, in the past it is likely that the rate of taking lump sums was higher, in part due to account balances of those in defined contribution pension schemes being relatively low. For lower account balances, the tax benefits of remaining within the private pension system are not large. Elderly Australians, particularly elderly women, commonly have low or no private pension account balance because they either never had pension contributions in the first place or they have exhausted their pension account balances.

However, clearly there is scope for more retirement benefits to be taken in income stream form.

Designing better postretirement arrangements

The primary purpose of pensions is to provide financial security in retirement. This purpose is not currently being achieved as much as it could be in Australia, as there are many potential leakages that are at a cost to the system's integrity and the taxation concessions provided.

These potential leakages include

- using pension benefits too fast, which manifests in several ways, such as having insufficient longevity protection and excessively running down retirement savings to either fund excessive consumption and/or debts that were built up in the lead up to retirement in the knowledge that a lump sum would be available; and
- using pension benefits too slowly (i.e., poor lifestyle in retirement) and leaving these benefits for others in the estate.

While the evidence available indicates that most retirees make sensible decisions regarding the investment of their retirement savings, there is scope to strengthen arrangements in advice, defaults, and compulsion.

The ASFA currently has a major project under way with the aim of facilitating or requiring the better provision of retirement income streams. This work is well under way but is not yet complete.

The following 11 guiding principles have influenced ASFA's thinking:

1) The main focus of pensions should be on income streams in retirement, as opposed to lump sums or estate planning. Pensions in the postretirement phase should be designed to ensure that pension income streams, in conjunction with full or partial Age Pension payments, provide income and dignity in retirement until death.
2) The retirement income system (including both tax concessions and Age Pension payments) must be perceived to be fair, when assessed across all components of the system and across the lifetime of individuals, including both the pre- and postretirement phases.
3) Changes should not undermine confidence in the system; that is, in terms of both the changes made and the need for long lead times.

4) The system must be comprehensive, covering people in different types of employment structures, such as employees, contractors, and the self-employed.
5) The retirement income system needs to be flexible, recognizing the need to take into account the varying patterns of work and lifetime income that exist. Phased retirement should also be encouraged as a means of helping people stay in the workforce longer, not as a tax evasion mechanism.
6) The retirement income system should be robust and able to withstand a range of reasonable economic conditions without significantly reducing the expectations of the individuals involved.
7) The means test for the Age Pension has an important role to play in determining the amount of government assistance that retirees receive. In particular, those individuals or family units who earn below average wages, or who spend time out of the workforce (e.g., to raise a family or because they cannot get a job) should receive substantial support from the government to achieve a basic income in retirement. On the other hand, individuals and couples who continue in paid employment past customary retirement age and/or who have substantial pension and other assets that support a lifestyle in retirement more substantial than that described in the ASFA Retirement Standard at the comfortable level should receive little or no Age Pension.
8) The mandatory pension system needs to have a relatively high degree of guidance and constraints (including good default systems) in order to protect people from unwise or excessively short-term actions. For example, it needs to
    - require long-term savings with restricted access prior to retirement,
    - provide income in retirement, and
    - reduce risks during both the accumulation and retirement phases.
9) There needs to be access to deferred annuities, the purchase of which could start in either the accumulation or drawdown

stage. This will necessitate the removal of prudential supervision and tax regulatory roadblocks in order to allow the offering of deferred annuities in either the accumulation or drawdown phase.

10) Incentives and default settings should be the initial approach to obtaining the desired outcomes. However, if such arrangements are not effective in producing desired outcomes, then consideration may need to be given to introducing a degree of compulsion with respect to the taking of income streams in retirement. For instance, this could be achieved through the application of tax penalties with respect to taking benefits in any one of the following:
    - as a lump sum,
    - in the form of a noncomplying income stream, or
    - if there is noncompliance with either the minimum or maximum drawdown factor of a complying account based income stream.
11) The requirements should apply to all pension structures, including self-managed superannuation funds, which are small plans, where provisions are relevant.

CONCLUSION

The Australian pensions system is not without its shortcomings. Among other things it is too complex, particularly in regard to the taxation of contributions and fund earnings, it is not yet mature enough to deliver for most a comfortable standard of living in retirement, and it does not deal well with the financial consequences of longevity for the large majority of members who are in defined contribution schemes.

However, compared to systems in most other countries, the Australian pensions system is sustainable, in that the respective burdens on governments, employers and individuals are manageable both now and in the future. It is comprehensive, in that all Australians benefit from an Age Pension from the government, which keeps individuals from poverty in retirement with near universal coverage of private pensions of employees and substantial coverage of the self employed. It is equitable, in that when all the elements of the system are looked at together, the amount of government assistance is broadly comparable across the income distribution. Finally, the Australian pension system helps to strengthen the financial system, in that assets in the pension system are invested in the real economy rather in notional securities issued by a central government.

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