FINANCIAL POLICY BRIEF

Putting the Age Pension Assets Taper Test into Perspective

FPB 2017 – 01: 20 January 2017

In this Financial Policy Brief, Professor Kevin Davis argues that the flip side of the changes to the asset taper test (that pension entitlement increases more rapidly as private assets decline) should not be ignored. For retirees willing to supplement pension receipts by running down assets over their expected life span (rather than leave them as a bequest), the effect of the changes on retirement living standards is substantially less than implied by simply focusing on the immediate change to current pension receipt amount. But concerns over longevity risk are one reason why retirees may not be inclined towards adopting such a strategy. This highlights the need for policies to facilitate longevity risk insurance products (such as reverse mortgages and CIPRs), as well as changing perspectives that the age pension is partly a mechanism for maintaining moderate retiree living standards while planning to pass on assets as a bequest to heirs. But also problematic for retiree decision making is regulatory risk. Assuming that there won't be further tightening of pension eligibility rules in the future may not be a good strategy – and this risk can adversely affect willingness to draw-down private assets to improve retirement living standards.

The changes to the age pension assets test arrangements introduced at the start of 2017 have created much angst and media commentary. The main focus has been on the immediate cost to part pensioners of a reduced current pension amount due to the increased taper rate (at which the pension entitlement is reduced as asset holdings increase) and changes to asset threshold levels.

But there has been no focus on the flip side which can largely counteract the adverse effect on possible living standards for many retirees. That flip side is that as the level of assets is drawn down in retirement, the taper rate acts in reverse once part pension entitlement is reached, such that the pension increase is at a higher rate than under the old rules.

What this means is that over the retirement phase, retirees who are willing to draw down their assets to supplement pension receipts and achieve a sustainable consumption level need not be markedly worse off. Although it depends on individual circumstances, they may be able to maintain much the same level of consumption in their retirement years with relatively little change in the age at which they exhaust holdings of private assets (other than the house). A sustainable, maximum, rate of consumption can be planned such that asset exhaustion occurs at around the time of expected mortality, with their bequest (if death occurs at that time) consisting solely of the family home.

Of course, this is where a critical philosophical/ideological issue comes into play. Is the age pension an entitlement which enables people to obtain government support in retirement despite having private assets which they do not draw down but instead leave as a bequest for their heirs? Or is it a safety net, which supplements draw down of private savings to enable some adequate level of retirement consumption?

Under the former view, the asset test changes hurt due to unwillingness to draw down private assets to offset a lower pension receipt and fund the same level of consumption. Or even if assets are drawn down, there is psychological hurt at having lower assets as a security blanket against longevity risk or available for ultimate bequest. Uncertainty about future policy changes, particularly if real pension benefits are thought likely to decline over time, is also relevant, potentially prompting precautionary hoarding of private assets.

Under the latter view, in which receipt of the pension is not perceived as a way to increase a bequest to one's heirs –but rather to facilitate an improved lifestyle in retirement - the hurt is very much reduced by the flip side of the taper.

The argument is perhaps best illustrated by a simple example – noting that specific circumstances and assumptions made will lead to different outcomes. Consider a home-owning couple retiring at age 67, with life expectancy (each) of 87. Under the pre 2017 assets test arrangements, they could have assets (additional to the family home) of $697,500 and receive a part pension initially of $18,743 p.a. which is half of the full pension. (The asset threshold for the full pension entitlement was $296,500, and the pension taper rate was $1.50 per fortnight per extra $1,000 of assets). If the couple planned to consume at a constant real rate until expected death, by drawing down their assets to zero at that time to supplement the pension, they could sustain a consumption level of around $60,000 p.a. (These approximate calculations assume a real interest rate of 2 per cent on assets, and ignore a number of complexities in the age pension arrangements).

Under the 2017 arrangements, the same couple could maintain close to the same level of consumption ($59,000 p.a.) throughout retirement till expected age of death. They would initially receive less pension ($9,227 in the first year) and need to draw down assets at a faster rate to achieve that similar consumption level. But as their assets decline pension receipts increase – and at a faster rate than under the pre 2017 arrangements. They would reach a point where they are entitled to a full pension sooner than under the pre 2017 arrangements. Continuing to draw down their assets they would, if they had tried to keep exactly the same level of consumption (since there is some overall negative impact), exhaust them sooner than under the old rules. At that point their consumption level would be limited to the level of the age pension, unless they then drew upon the equity in their home (such as by downsizing, using a reverse mortgage, or as part of shifting into aged care accommodation). This decline in living standards would also occur if they survived beyond their expected mortality.

This example is purely illustrative and the specific results will vary in practice for different individuals and couples, with many facing some fall in their sustainable consumption level. (Ongoing joint work by researchers at Willis Towers Watson and the University of Melbourne makes more precise calculations to examine how retirement consumption levels would be affected– see https://www.towerswatson.com/en-AU/Insights/Newsletters/Asia-Pacific/view/2016/retirement-adequacy-are-we-still-making-progress).

But this relatively simplistic example has been used to emphasize three points.

First, a higher taper rate also works in reverse to give higher pension increases as assets are drawn down.

Second, under the view that the pension supplements private wealth drawdown to achieve higher retirement consumption, rather than facilitating bequests, the adverse consequences of the 2017 changes are significantly less than the media focus on the change in the current pension amount received by many part-pension recipients would suggest. Shifting the focus of retirement income discussion to achievable levels of consumption in retirement, rather than levels of retirement savings (super and other assets) and pension entitlements would help generate a better informed discussion. But doing so also requires inculcating or reinforcing the view that the age pension is not an "entitlement" but rather a safety net to supplement private savings in achieving an adequate level of retirement consumption.

Third, drawing down private assets to maximise the retirement consumption stream achievable (from drawdown, earnings on assets, and pension receipts) till age of expected death (when private assets are exhausted), creates exposure to longevity risk. Home ownership provides a buffer against such risk for many individuals, but social attitudes (which inhibit drawing down home equity rather than providing a bequest to heirs) and a lack of attractive mechanisms to enable home equity release, have limited use of that buffer. Rectifying that, as well as introduction of CIPRs (Comprehensive Income Products for Retirement) are important steps towards reducing longevity risk which can induce unwillingness to run down private wealth which otherwise serves as a buffer against such risk.

This Financial Policy Brief was prepared by Professor Kevin Davis, Research Director of the Australian Centre for Financial Studies.

ACFS Financial Policy Briefs (previously called Financial Regulation Discussion Papers) provide independent analysis and commentary on current issues in financial regulation with the objective of promoting constructive dialogue among academics, industry practitioners, policymakers and regulators and contributing to excellence in Australian financial system regulation.

For more in this series, visit: australiancentre.com.au/publications/policy-briefs

About the Australian Centre for Financial Studies

The Australian Centre for Financial Studies (ACFS) is a part of Monash Business School. It aims to facilitate industry-relevant, rigorous research and independent commentary, drawing on expertise from academia, industry and government to promote thought leadership in the financial sector.

Together, ACFS and Monash Business School aim to boost the global credentials of Australia's finance industry, bridging the gap between research and industry and supporting Australia as an international centre for finance practice, research and education.

www.australiancentre.com.au | business.monash.edu