A Submission to the Retirement Incomes Review

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This submission makes 5 main points relevant to the future prospects for efficiently achieving adequate retirement incomes for older Australians. While these involve policy options for the future they address reasons for why current retirement income policy is sub-optimal. The issues are as follows:

1. Retirement income products offering some form of promised amount should be covered by the Financial Claims Scheme.
2. The Pension Loans Scheme enabling retirees to obtain an enhanced age pension using housing equity as collateral warrants modifications to enhance its usage.
3. The Work Bonus Scheme allowing retirees to earn some income without it affecting pension amount should be reconsidered to incorporate a scheme providing the option for individuals to obtain a higher age pension by continuing in work beyond the pension age and deferring access to the age pension.
4. The Assets Test "taper rate" for pension eligibility should not be lowered.
5. A "radical" option for improving retirement incomes policy would be to introduce a universal non-means-tested pension, accompanied by taxation of superfund earnings in retirement. As explained later, it appears that this could be structured to be near budget neutral with no reduction in after-tax retirement income for retirees with incomes below some threshold level such as $100,000 p.a. Note that this would remove the need for the Assets Test (point 4). While "radical" it is my view that the benefits which could flow from such a change make it worth further investigation, rather than a focus solely on marginal changes to current policy settings.

1 Financial Claims Scheme (FCS) Coverage of Retirement Income Products

When the FCS was introduced in 2008, its coverage was limited to deposits at Authorised Deposit Taking Institutions (ADIs) and insurance policies issued by general insurers. The reasons for excluding insurance policies provided by life insurers were not stated, even though these were considered in the Study of Financial System Guarantees[1] (Davis, 2004) commissioned by the Government following the failure of the HIH Insurance group. That report noted (p81) that "guaranteed annuity and pension products ….may warrant inclusion in any guarantee scheme".

One possible reason for excluding life insurance policies could be that risk management by providers of such policies, accompanied by strong capital (solvency) requirements makes the likelihood of failure of providers and shortfalls on promises made highly unlikely. While that may be so in the case of conventional life insurance products, if reliable mortality tables exist and portfolio

[1] Davis, K. et al *Study of Financial System Guarantees,* 2004*, https://treasury.gov.au/publication/p2004-45061*

immunisation strategies are followed, it is less clearly the case for retirement income products providing insurance against longevity risk and potentially other risks facing retirees.

It is difficult to imagine that collapse of a prudentially regulated provider of lifetime annuities or other similar retirement income products would not lead to a government providing compensation to investors in such products. Most such individuals would be at a stage of their life where options to offset the loss of promised income (such as by re-entering the work-force, or drawing upon other savings) would be extremely limited. Government incentives and inducements for individuals to invest in such retirement income products offered by prudentially regulated private providers could be expected to lead to community expectations that there is "implicit insurance" by the government against losses from failures of those providers.

Unlike the case of insured ADI deposits, explicit FCS coverage of retirement income products may warrant charging of a fee. In the case of deposits, other providers of funding to the ADI have junior ranking to insured deposits in the event of insolvency and thus provide a layer of protection for the deposit insurer (APRA) which should be reflected in higher interest rates demanded on those subordinated funds. Because the resulting balance sheet structure of ADIs, and priority structure leads to miniscule chance that the deposit insurer (APRA) will incur a loss, levying an explicit fee would thus be equivalent to double-charging.

However, retirement income products are claims on a pool of assets which are funded by only the contributions made by policy-holders and equity. Other than the equity buffer, there is no junior level of fund-providers to bear the risk that asset values are insufficient to meet obligations to policy-holders. Consequently, a fee for FCS protection linked to the risk of failure of the provider is warranted. Higher equity (capital) buffers provided by the provider's owners would *cet par* be associated with lower FCS fees.

2 Pension Loans Scheme (PLS)

This is potentially a valuable complement to Reverse Mortgages provided by private financial intermediaries. Such a scheme can help overcome the problem of asset-rich, income-poor households having lower than preferable consumption expenditure in retirement years by not generating cash by running down the equity in their house.

There is, unfortunately, apparently no readily available public information on the take-up of the scheme. This may reflect the general lack of interest in reverse mortgage schemes among retirees who have been conditioned over time to reducing indebtedness, rather than increasing it as occurs in reverse mortgages (and with the PLS).

But, to the extent that the PLS has not attracted much interest, that may reflect either or both of its design and marketing features. The outline of the scheme provided at https://www.humanservices.gov.au/individuals/services/centrelink/pension-loans-scheme

seems very unlikely to encourage interest.

First, calling the fortnightly payments a loan – while strictly correct - does not frame the issue in a way likely to encourage participation. The participant is in fact obtaining early access (for a price represented by the interest rate charged) to the equity tied up in their house. A simple change of terminology to something like a Home Equity Access Scheme could be considered, with fortnightly payments referred to as the home equity access receipt rate. There is also the problem that the current terminology uses the term loan to refer to both the amount received each fortnight as well as the cumulative amount of receipts (and interest accrued).

Second, the information provided on the repayment obligation arrangements warrants improvement. Such a scheme is most likely to be attractive if it is crystal-clear that there are no repayment obligations until the property used as security is sold – although earlier repayment is possible. That is not emphasised sufficiently, nor is the fact that loss of ownership of the property is not created by using the scheme.

Third, the website uses the terms “pension and loan payments” when it is referring to cash flows received by the household. Since most individuals will likely have become accustomed to thinking of loan payments as the cash outflows associated with repayment of a loan, better terminology could be used.

Fourth, the tables used to show the effects of compound interest over time on the loan balance, do not put this into a useful perspective by comparing that amount against some (hypothetical) estimates of the value of the property used as security at those future dates. Some simple examples of how the household equity in the property at future dates would be affected would provide a more balanced perspective on the net effect of participating.

Fifth, the explanation of how the maximum fortnightly amount (or total maximum outstanding balance) is calculated, while specific, is not at all intuitive.

Sixth, there does not appear to be any statement emphasizing that the fortnightly amounts received are tax free and are not counted in the income test – both important considerations for potential users of the scheme.

Seventh, potential users of the scheme may have experienced periods earlier in life when interest rates increased dramatically, making mortgage repayments much greater. While the current interest rate is 4.5 per cent p.a., the possibility that this might be increased at future dates may be a deterrent to participation. Imposing some cap on the maximum rate that could be charged over the term of participation would reduce any such concerns. The Government can hedge the interest rate risk either through funding the scheme through fixed interest borrowings of similar duration or via hedging in financial markets.

Finally, there does not appear to be any public information on the operating costs of the scheme. But the current interest rate charged of 4.50% p.a. is significantly higher than, for example, the 10 year government bond rate of around 1.20% p.a. Promoting increased use of the scheme may, depending on the level of operating costs, actually be budget-positive for the government due to this interest differential between interest rate charged and government funding costs. Arguably, enabling low-income retirees to attain a higher living standard via scheme participation (which is desirable in itself) may also reduce their demands on other government services and reduce such costs.

3 The Work Bonus Scheme and Alternatives

“Fairness” is an important consideration in the design of retirement incomes policy. The existence of a universal, means-tested, age pension, inherently reflects “fairness” considerations, by ensuring that some minimal level of support is available to all individuals beyond some age – at which they may no longer be able to generate income through employment or running down of accumulated savings. But, it can be argued, current arrangements mean that it is not “actuarially fair”, potentially biasing retirement decisions

A relevant concept for considerations of alternative policies is an "actuarially fair" pension. This is based on thinking of the pension as a "lifetime annuity" which, subject to some wealth related eligibility conditions, should be available and of equal expected value to all recipients. The expected value for any individual will depend on the number of years from commencement of the pension to expected death. Thus, an individual who works to an older age should expect (for actuarial fairness) to receive a larger annual pension than one who retires earlier. (This type of approach applies for the US Social Security System and in reforms in the 1990s to Italian and Swedish schemes, which adopted "notional defined contribution schemes"[2]. Compounding the inequity, if this is not the case, individuals who retire later and/or who have had more years in employment can be expected to have, on average, contributed more to the taxation revenue needed to sustain the pension system.

An arrangement of this sort (the Pension Bonus Scheme) was introduced by the Howard Government in the 1997-98 Budget, providing that those who "deferred age pension take-up while continuing to work a minimum of 25 hours per week, accrued a cumulative tax exempt bonus entitlement of 9.4 per cent of his or her basic pension entitlement for each full year of employment past pension qualifying age (maximum 5 years deferral)"[3]. This scheme was closed to new entrants who had not qualified for the age pension by 20 September 2009.

It was replaced by the "Work Bonus" scheme whereby an increased allowance was made for income earned in calculating the income test for pension eligibility. (Only 50 per cent of earned income up to a maximum of $500 per fortnight was included initially. Currently, the scheme involves a relatively complex arrangement whereby a notional "Work Bonus" account is created which if the pension recipient does not earn income from work increases by $300 per fortnight to a maximum of $7,800. Income received from work reduces the account balance without being included in income eligible for the means test as long as the account balance is above $0.

While the "Work Bonus" scheme increases the incentive for retirees to undertake some paid work (by reducing the adverse effect on pension income via the means test) it does not do anything (or much) to reduce incentives to retire and access the age pension. An individual of pension age currently working faces a high effective marginal tax rate (in an opportunity cost sense) from remaining in work for that year, relative to the alternative of retiring and accessing the age pension. Not only is tax paid on income earned but the age pension amount for that year is foregone (as is the value of leisure time lost from being in work versus retired).

It would seem appropriate and less actuarially unfair to remove such disincentives to continuing in work, and not accessing the age pension, among those of retirement age. A re-instatement of some scheme akin to the previous Pension Bonus Scheme is worthy of consideration.

4 The Age Pension Assets Taper Test

Changes in 2017 to the "taper rate" increased the rate at which the age pension was reduced as assets owned by the retiree were higher. While this attracted criticism from many, the criticism neglects the fact that such retirees could supplement current consumption by running down their

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[2]Hairault J, Langot, F and Sopraseuth T (2010). Distance to Retirement and Older Workers' Employment : The Case For Delaying the Retirement Age,
Journal of the European Economic Association 8, 5 (2010) 1034-1076

[3]The Treasury (2001). Towards higher retirement incomes for Australians: a history of the Australian retireme nt income system since Federation. https://treasury.gov.au/publication/economic-roundup-centenary-edition-2001/article-3-towards-higher-retirement-incomes-for-australians-a-history-of-the-australian-retirement-income-system-since-federation

assets. As assets run down, the "flip side" of the taper test comes into play such that there is an increase in the rate at which the available pension increases. Consequently the overall level of retirement phase consumption need not be much affected. However, the extent to which individuals are reticent to run down assets due to concerns about longevity risk or regulatory risk, or desires to leave bequests to their heirs may inhibit them adopting such strategies. These issues are discussed in detail in ACFS Financial Policy Brief 2017-01.[4]

5 Introduction of a Universal Age Pension

Our current tax and benefit treatment of retirement incomes is a mess. It can be improved in a politically feasible way by a policy change combining the introduction of a universal (non-means tested) age pension together with restoration of taxation of super income in the pension phase, and some other tax changes.

Any policy change involves winners and losers, but a judicious choice of tax rates can mean that the only losers will be those with retirement superannuation balances currently generating tax free income in the region of $100,000 p.a and above. Squeals would be heard, but the number of squealers would be relatively small and unlikely to gain much sympathy. And the change could be near budget neutral.

Why is our current system a mess? Complexity and adverse incentives and distributional outcomes. Currently much of financial planning seems to be about structuring affairs to maximize age pension entitlements. The age pension means test and other eligibility requirements create bureaucratic nightmares and involve significant resource costs for their implementation. There are ongoing fights about the taper rate (at which other income reduces pension eligibility).

There are also ongoing debates about distributional features of the current system. Then-Treasurer Costello's introduction of a zero-tax regime for super fund earnings in the pension phase has proven misguided. The scale of the benefits to wealthy households is inequitable and has necessitated a range of complicated administrative measures to limit such benefits. Under our imputation tax system, government corporate tax revenue is cannibalized via dividends being paid to zero tax rate super funds.

What would be the effects of introducing a universal age pension (removing huge bureaucratic costs) and taxing pension-mode superannuation earnings? Ball-park figures can illustrate that this is a feasible change. For simplicity, the figures calculated below assume all retirees are treated as individuals rather than couples and all non-age-pension-income is from super. The world is more complex obviously, but the calculations are designed to indicate that the proposed solution is worth considering and warranting more sophisticated modeling to incorporate those complexities.

The mechanics of the proposal involve either the shift into retirement (or reaching of retirement age), triggering (a) receipt of the full age pension and (b) the retiree's superannuation fund(s) being converted into retirement mode and earnings on the fund being included in personal income for tax purposes. Thus super fund earnings in retirement mode would go from being untaxed to being taxed as part of the individual's taxable income at the relevant rate. Retirees with additional super fund balances still in accumulation mode (being above the $1.6 million threshold) would then have

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[4] Putting the Age Pension Assets Taper Test into Perspective. http://www.kevindavis.com.au/secondpages/ACFS%20Financial%20Policy%20Briefs/2017-01-FPB-%20Putting%20the%20Age%20Pension%20Assets%20Taper%20Test%20into%20Perspective.pdf

earnings on those balances taxed at their personal tax rate rather than at the concessional rate. Whether automatic triggering occurs at retirement age or on announcement of retirement is a policy choice to be made after more detailed consideration of the proposal's implications. Also incorporated in the proposal in calculating budgetary effects is the removal of the Senior's Tax Offset, which would become largely irrelevant under the assumptions used here (but may need some modification when income from other than superannuation is considered).

Any calculations of the effects, based on current statistics, of the changes proposed are at best ball-park, since behavioural responses can be expected. And the benefits of those behavioural responses is part of the rationale for the proposal. Less resources would be wasted in pre-retirement advice aimed at increasing pension eligibility, the pension application process would be markedly simplified, and assets and income tests would no longer be required. Maintenance of large balances in superannuation post retirement as tax-preferred estate planning (inconsistent with the rationale for super tax concessions) would no longer be as attractive. There would be no disincentive to save in the pre-retirement phase due to concerns about reduced pension-eligibility (although the post-retirement equality of tax treatment of super and non-super income would marginally reduce incentives for pre-retirement allocation of voluntary savings into super versus other investments). How incentives to work beyond retirement age (or retire prior to pension eligibility age) would be affected would differ for different income groups and depend on details of the policy changes.

The ball-park figures used here are as follows. There are approximately 4 million people over pension eligibility age of which around 45 per cent (1.8 million) currently get the full pension of $20,000 approximately, 35 per cent (1.4 million) a part pension, and 20 percent (0.8 million) no pension. The last group are ineligible since (ignoring the assets test) other income (initially assumed for both them and part pensioners to be all from super) is above approximately $50,000. The average part-pensioner is assumed to have $25,000 super income and receive $10,000 of pension. (The effect on the calculations of retirees having non-super income is considered later).

If a universal pension were introduced, earnings of super funds in the pension mode were taxed at current individual tax rates, and the seniors tax offset (which means no tax is generally payable below income of $35,00) is removed, the following would result. First existing full pensioners would be generally unaffected. The average part-pensioner (currently receiving $10,000 pension and $25,000 tax free super income, ie $35,000 after tax) would now receive $20,000 pension giving a total income of $45,000 which would be subject to tax. At the current tax scales (after removing the Senior's Tax Offset scheme), tax would be around $6,000 giving increased after-tax income of $39,000 (a $4,000 increase).

For those just at the pension cut-off level (having $50,000 tax free super income), the combination of now receiving the full pension and having income taxed would result in them having an increase in after tax income from $50,000 to around $56,500 (a $6,500 increase). For a non-pensioner with $70,000 tax free super income, the net result would be virtually no change in after tax income since tax payments now required would be roughly the same as the age pension income now received). Those with higher super income would be worse off.

But could the government budget afford such a change? Yes – particularly with a few tweaks to the tax rates.

Extra pension payments would be in the order of $30 billion p.a. This reflects the 1.4 million part pensioners getting an extra $10,000 p.a. on average ($14 billion in total) and the 0.8 million non-pensioners getting $20,000 p.a. each ($16 billion in total).

But tax revenue could increase by around $21 billion assuming half of non-pensioners had around $700,000 in super in pension mode generating (at an earnings rate of around 7 per cent p.a.) an annual income of $50,000 p.a. (just missing out on a part pension) and the rest having an average of $1 million generating income of $70,000 p.a. Current non-pensioners would pay tax of around $13 billion, and part pensioners' contributions would be around $8 billion).

That is a shortfall of $9 billion - more if super income of those in retirement mode is less than assumed. One reason is that the changes (under the numbers used here) lead to current part pensioners, and those just above the part pension eligibility level, having higher after-tax incomes (approximately $5.9 billion and $2.6 billion in total respectively). Tax scale, and other, changes which kept after tax incomes for those groups unchanged could rectify the imbalance in the budget calculations.

What difference does it make if the income of part-pensioners and self-funded (non-pensioner) retirees is outside of super? Assume that it all is – since this will give the alternative polar extreme, with reality somewhere in between the two sets of calculations.

First, current full – pensioners are unaffected as before. Second, the effect on the average part pensioner is the same as before, Their taxable income of $35,000 ($10,000 pension and $25,000 other income) involved zero tax due to the Senior's Tax Offset. They now have pre-tax income of $45,000 (due to the additional $10,000 pension) and (in the absence of the Senior's Tax Offset) pay around $6,000 tax, leaving them around $4,000 better off.

Third, however, the current non-pensioners having taxable rather than currently non-taxable super income would be significantly better off (without other changes to the tax scales). The marginal (borderline) non-pensioner with pre-tax income of $50,000 would have had after-tax income of around $46,000. After the policy change, the after tax income increases to just over $56,000 with the $20,000 increase in pension income not being fully offset by the removal of the Seniors Tax Offset. For the non-pensioner with $70,000 pre tax income, the changes mean an increase in after tax income of around $10,500.

These greater benefits to current non-pensioners together with the part-pensioner benefits (around $15 billion in aggregate) of course make the budget implications more severe. The $30 billion additional pension payments are only offset by around $15 billion additional tax revenue. But again, this could be offset by appropriate changes to tax scales etc which make current part – and non-pensioners no worse off and raise the required sum to balance the budget implications.

Of course, nothing is this simple. Consequences and incentives for early retirement need consideration, as does more detailed analysis of the importance of non-super versus super income in retirement. There are bound to be particular groups within the part-pensioner category where the analysis here based on an "average" part-pensioner hides particular complications. Tax arbitrage involving imputation credits could foul the figures – suggesting at least a need to revisit and remove the rebates for unused tax credits. Under this proposal, that shouldn't be a deal-breaker for most retirees, but probably would meet opposition from those in accumulation mode (and other low tax rate investors).

But the proposal, if radical, appears feasible and has the potential to reduce much of the bureaucracy and costs associated with age pension administration and tax complexity and regulations regarding superannuation. Rather than fiddling at the edges, consideration of wholesale reform is warranted.