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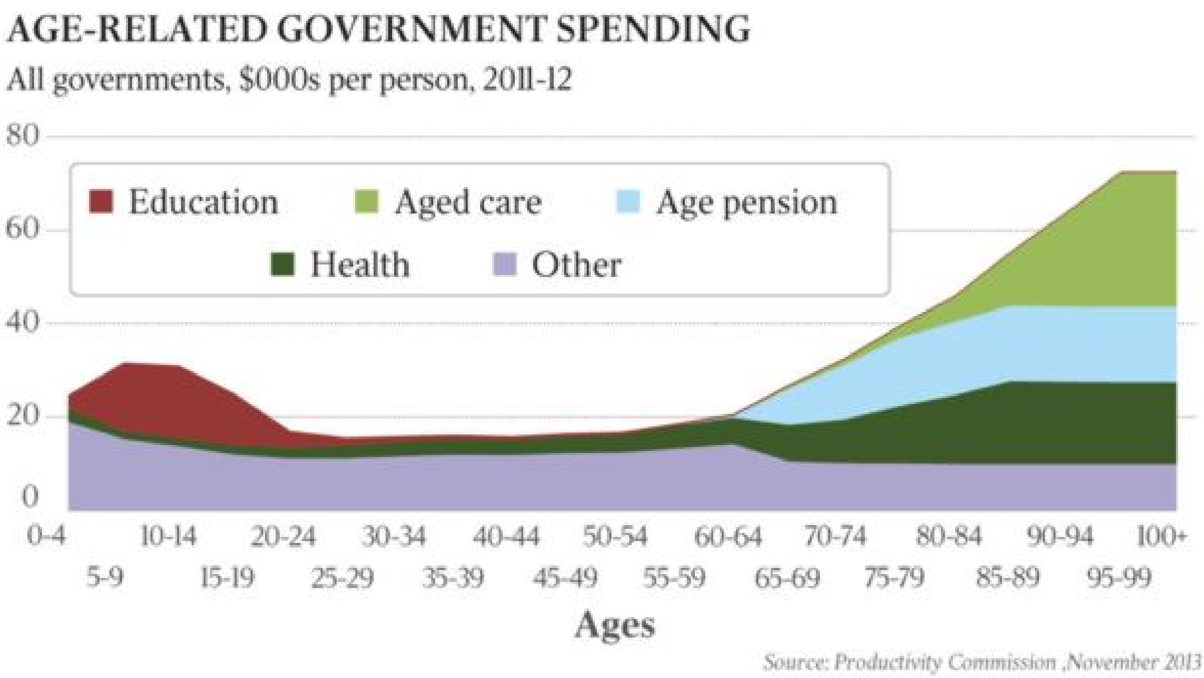
Grab for pension is not helping

HENRY ERGAS THE AUSTRALIAN FEBRUARY 21, 2015 12:00AM



WITH Joe Hockey warning that the imminent Intergenerational Report will knock people "off their chairs", the cost of our retirement income system is unlikely to disappear from the front pages anytime soon. But reconciling fiscal sustainability and community expectations is every bit as politically challenging as it is technically complex.

Not that there is a lack of urgency. As life expectancy at birth continues to rise by more than two months a year, an unprecedented number of Australians are surviving into their 80s and 90s, placing increasing pressure on the age pension. In 1909, when the pension was introduced, one Australian in 25 was 65 or older, and merely one in 500 had made it to 85; by 2050, the share of the population 65 or older will be closer to one in four, while one Australian in 20 will be at least 85.

Little wonder then that spending on the aged pension has been increasing by about 4.5 per cent a year in inflation-adjusted terms, which is more than twice the rate of growth of per capita incomes.

Adding to the urgency, the politics of reforming retirement income policies aren't going to get any easier. Rather, higher life expectancy is also reshaping the electorate: in 1980, the average voter was 38; in 2050, they will be 50, making reforms to the pension or to superannuation all the more fraught for governments.

Unfortunately, there are no painless options for placing our retirement incomes system on a sounder fiscal basis; and many of the most sensible options would yield budget savings that, at least in the short term, are quite small.

Sizeable, durable improvements can be secured only in the long run, requiring a far greater degree of consensus than our fractured politics seems capable of achieving.

That isn't to say there aren't changes that can and should be made. On the contrary, the need to implement reforms gradually merely increases the importance of starting now. And with the share of the population aged 65 and older receiving at least a part pension set to remain virtually constant at about 80 per cent for some decades to come, the age pension is a good place to start.

Here the trade-off is simple: the higher the pension's level, the tighter eligibility must be for the system to be fiscally affordable, at least on present revenue projections. Views differ, however, as to whether the income the pension now provides is unduly generous.

Reviewing that issue, the National Commission of Audit argued that with female labour force participation rising, the link between the level of the pension and male total average weekly earnings was an "anachronism".

As an alternative, it recommended shifting the benchmark from 27.7 per cent of MTAWE to 28 per cent of average weekly earnings (which is calculated for both male and female employees), so reducing the expected level of the pension in 2030 by 20 per cent.

To get to that lower level, it suggested freezing the pension in real terms until 2027-28, generating substantial gains to the budget bottom line. Indeed, on an admittedly rough estimate, that proposal alone accounts for more than half the audit's $40 billion of projected savings in budget spending on the pension in 2050, and for two-thirds of the cumulative saving in pension spending until then.

But the commission's proposal is understandably controversial. Despite the substantial increase in the standard pension in 2009, our replacement rate (the proportion of former salary that the pension provides) is not especially high by advanced economy standards, and is well below the average for middle and upper income earners.

Moreover, few countries, if any, have succeeded in holding the real level of the pension constant for an extended period.

Rather, experience in Britain shows that as pressures for an increase in the real value of the pension mount, top-up payments and special supplements proliferate, making the system more opaque and arbitrary.

So, while indexing the pension to the consumer price index for two to three years may be sensible, it is neither realistic nor desirable to prevent periodic adjustments as overall incomes rise.

That places more of the burden of meeting budget constraints on eligibility tests.

After all, although originally tightly means-tested, a process of progressively broadening the eligibility criteria that began in 1969 raised the proportion of older Australians receiving the age pension from about a third to nearly 80 per cent.

A step towards tightening eligibility was taken with the decision to increase the age at which the pension could be received to 67 by 2023. And there may well be scope for further increases after that, as higher life expectancy, along with improvements in the health status of people in early old age, create opportunities for extending working life.

But the greatest effect on eligibility would come from changes to means-testing.

There is a compelling argument for streamlining the current tests, including by having a single, comprehensive test instead of separate income and asset tests.

However, already now, most pensioners have relatively low incomes: even for couples receiving only part pensions, just 20 per cent have annual incomes that exceed $30,000 and the share earning more than $35,000 is a small fraction of that.

With virtually no high-income earners qualifying even for a part-pension, any real impact of changes in the eligibility criteria must come from revising the assets component of the test, which raises the immensely contentious issue of the treatment of the family home.

No one could deny that its exclusion from the means test has substantial effects, favouring those whose investments are concentrated on the family home. Under the present rules, for example, an older person who owns a $400,000 house and has $750,000 in shares would not be eligible for the pension, while one with a principal residence worth $2 million and $100,000 in shares (and so nearly twice as many assets in total) would receive the pension in full.

As well as being inequitable, the result is to induce Australians to hold an even greater share of their assets in the form of real estate than they otherwise would, which not only distorts the housing market but also increases the harm a sharp fall in property prices would cause. And the exclusion of the family home narrows the base to which the means test is applied, requiring the means test on other assets to be inefficiently higher.

There is, therefore, good sense in the audit commission’s recommendation that the means test be extended to include a proportion of the value of the family home above a substantial indexed threshold.

However, many older households have saved by building equity in their home, with the result that they are asset rich but income poor. And while there are financial products that allow homeowners to draw down the value of their equity, any abrupt changes to means-testing arrangements would likely cause significant hardship.

That underscores the importance of a gradual, phased transition, with the audit commission suggesting the expanded test not be implemented until 2027-28 and then just to new applicants for the pension.

Because of that delay, and because the commission’s proposed test cut in only at an indexed home value above $500,000 for single pensioners and $750,000 for couples, the budget gains from including the family home are small, amounting (again on a rough estimate) to less than 5 per cent of the savings on pension outlays the commission envisaged to 2050.

But they should build up rapidly, reducing the number of part-pensioners and so generating some added savings in terms of the health card concessions that are linked to pension eligibility. And as the base to which the pensions means test is applied is broadened, the point at which the pension begins to taper off would be lowered.

Whether such a reform (which would broaden the base of the means test but use some of the savings to lower its taper rate) has any prospect of political acceptability is obviously uncertain.

But those prospects would be improved only were it paralleled by reforms that make our superannuation system more efficient, increasing the savings on which older Australians can rely and so reducing their dependence on the age pension.

It is true that instead of addressing how well the system works in promoting retirement savings, much of the debate about superannuation has involved polemics about the tax concessions it attracts. And to make matters worse, most of the claims made in that debate are poorly informed.

For instance, effective tax rates on the income of long-term superannuation savings are not especially low: on the contrary, properly calculated, they are relatively close to the top income tax rate.

But that isn't to deny that there is considerable scope for reforming the taxation of super. Rather, the recommendations of the Henry tax review, which would tax contributions at a discount to the saver's income tax rate while halving the tax rate on accumulation (earnings), make sense, both for the superannuation system itself and in moving our tax structure towards one that is neutral between different forms of saving.

There would also be gains from more closely aligning taxation in the retirement phase with that during accumulation, closing off the tax arbitrage possibilities that the present arrangements (which encourage "cycling" income through super during retirement) create.

Yet every bit as important as tax reform is improving efficiency in the system and decreasing the very high costs it imposes on savers. The Murray inquiry into the financial system, for example, found that reducing average fees in funds regulated by the Australian Prudential Regulation Authority by just 30 basis points would increase their members' balances by more than $3.5 billion a year, providing the average male employee with an extra $2000 in income for each year in retirement.

Two reforms hold the key to achieving those gains. The first, which should be implemented immediately, is to give all savers a choice of funds, freeing the 20 per cent of employees who are denied choice by enterprise agreements, workplace determinations or awards.

The second is to introduce competitive tendering for all default superannuation products, with the Murray report concluding that despite a substantial increase in market scale (which should have reduced unit costs), fees for these products have tended to rise.

Admittedly, a transition to competitive tendering for default products would take time. But given the size of the potential benefits David Murray points to, there is surely no reason to wait until 2020, as the report recommends. Instead, beginning that transition now, and so accelerating the reduction in fees, would make a change in tax arrangements all the more acceptable to savers.

Doubtless these reforms will meet fierce opposition, not least from the unions. But it would be disappointing if support could not be built for a package that increased equity and sustainability throughout the retirement income system, including by reducing higher income earners' access to the age pension.

And the precedents are not entirely unfavourable. Labor's changes to aged care are a case in point. Albeit far from perfect, these include in the means test that determines the daily care fee for residential care part of the value of the family home, so long as it is not occupied by the partner of the care recipient. And they increase the share of the costs of high-level residential care that will be borne by users by 10 percentage points, while users' co-payments for community care rise from 5 per cent of costs to about 20 per cent. But those changes, which the Abbott government implemented from July 1 last year, were not met by howls of protest.

That is partly because they provided clear benefits in allowing a much-needed expansion in aged-care places — highlighting the importance of establishing a clear link to fiscal sustainability. Every bit as important, however, was the fact the changes received at least qualified support from the opposition and the crossbench, not least because they built on a well-researched Productivity Commission report that involved extensive public consultation.

For sure, those preconditions are no magic bullet, especially in an area that offers as much scope for political mischief as retirement incomes do. But perhaps they offer a glimmer of hope that good sense will prevail. The alternative, of course, is to kick the can farther down the road, allowing the difficulties to become ever more intractable. It may be that this is the best our political leaders can do; but, if so, the only end in sight will be their own.